

BANKING AND FINANCE



Text Book of
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Dr. N.K. Sharma



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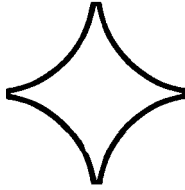
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PREFACE

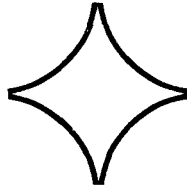
The study of money and banking is very much useful in modern business and commerce because modern trade, commerce and industry's problems have become so complex that decision maker's personal experience is no longer adequate to provide an appropriate solution. It has, therefore, become essential for persons associated with decision making to possess at least a working knowledge of the relevant tools of analysis. The purpose of this book is to provide in one volume, the various money and banking concepts which are deemed to constitute the subject matter of this book. This book is intended to explain in non-technical language, the money and banking concepts, tools of analysis, their relevance in business decision making and also the influences of banking environment on business and commerce decisions. The scope of money and banking is still in a state of flux and it may remain so in a computer based dynamic economy with modern outlook of management.

It gives me great pleasure to place this book before the students, learned teachers, professionals and business executives. This book has been designed especially for the students of B.Com., B.A., BBA, M.Com., M.A., MBA, etc., of various Indian Universities.

I shall be thankful to the readers and teachers for pointing out discrepancies and errors in the text, which I hope to rectify further improvement of this book, will be highly appreciated.

Author

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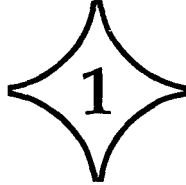


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CHAPTER



INTRODUCTION

The British East India Company established "The Hindustan Bank" in Kolkata and Mumbai in 1770 and later in 1785 established other banks. In early nineteenth century three Presidency Banks, *i.e.*, Bank of Bengal, Bank of Bombay and Bank of Madras were established. The first important event in the history of banking in India took place in 1919 when the Presidency Banks were amalgamated and Imperial Bank of India was set up. Banking Companies (Inspection Ordinance) was passed in January 1946, and in February 1946, Banking Companies (Restriction of Branches) Act was passed. In 1949, the Banking Companies Act was passed which was later amended to read as Banking Regulation Act.

On 19 July, 1969 an ordinance was issued by the central government acquiring ownership and control of 14 major banks in our country. This was done to bring commercial banks into the mainstream of economic development with definite social obligations and objectives. Two major aspects of nationalization were: (1) rapid branch expansion and (2) channelling of credit according to plan priorities. Later, on 5 April 1980, six more commercial banks were nationalised. After the submission of recommendations of the Committee headed by Chairman Shri M. Narasimham, a comprehensive reform of the banking system was

introduced in 1992-93. The main aim of the reform measures was to ensure that the balance sheets of banks must reflect their actual financial health.

In 1993 new private sector banks were allowed to be set up in the Indian Banking System to increase productivity and efficiency of our banking system. A committee headed by Shri M. Narasimham, to examine the record of implementation of financial system reforms recommended by the CFS in 1991 was constituted in December 1997. In 2001 the revised guidelines for entry of new banks in private sector were issued. Subsequently, for the conversion of Non Banking Financial Corporations into Scheduled Banks, guidelines were also issued.

Role of Banking Sector :

According to Prof. M.S. Chhikara, "Banking sector, managing the demand and supply functions of money, plays an important role for promoting a healthy, balanced and sustainable development of a country. It is considered as the most important segment responsible for accelerating as well as slowing down the national and global economies. Movements in this sector have almost one-to-one relationship with the growth of an economy. A strong financial and banking sector gives the necessary support to the economic system to function effectively and vice versa, so, a sound, systematic and dynamic banking system occupies a pivotal position in the economy "world over and supports them to emerge as business leaders."

With the intensification of the pace of the ongoing economic and financial sector reforms for more liberalization and globalization of the Indian economy, the Indian banking industry is undergoing a paradigm change in scope, content, structure, functions and governance. The information and communication technology revolution is radically and perceptibly changing the operational environment of the Banks, in our country.

Banks offer following services to their account holders at their specified branches:

- Multi-city/ payable at par (PAP) cheque facility.

- Any where banking facility and internet banking facility.
- Credit card, debit/ATM card, mobile banking and Real-Time Gross Settlement (RTGS).
- Gradually, foreign banks are expanding the number of production offer, their complexity such as derivatives, leverage financing, *etc.*
- Doorstep banking facilities are being offered by some of these banks to cater to convenience lifestyle of its customers.
- Private banks are extending services including wealth management and equity trading apart from credit cards.

Emerging Trends :

The traditional distinctions between banking and other financial services like insurance on one side and between commercial banking, developmental banking and investment banking are getting blurred. The emergence of universal banking and bank assurance are clearly pointers. This global convergence of financial services may gather further momentum in the years to come.

The banking and insurance sector reforms have encouraged private sector players to make forays into the business in collaboration with major international companies. This new scenario will witness financially sound and experienced players transforming the industry with best practices in product development, operational efficiency, marketing capability, service focus, and tech-savvy orientation. Thus, there is a need for intensive, futuristic and career-oriented programs in these two areas: Banking and Insurance. These developments in Banking and Insurance industry call for competent and professionally trained managers. As observed Dr. A.B.C. Raj, Chancellor, the ICFAI University, in one of his recent messages.

Increasing competition, thinner spreads and introduction of new technology driven products are some of the trends that the Indian banking system is experiencing. "Recent trends in Indian banking have reflected the efforts of the major players to adapt to a rapidly liberalizing and globalising environment. While the impact

of these changes is possibly a subject of debate, there is one group which is not complaining - the customers, the beneficiaries of the process of liberalization", observed Amitabh Guha, State Bank of Travancore.

Further, the technology oriented banking has become one of the latest mantras of success in the market, especially to win over the customers. To this, says SBI Chairman AK Purwar, "Indian banks need to fuel the market by bringing new products at par with the international standards, extending ATM facility to rural areas and vibrant networking countrywide to compete with the new generation and the MNC banks in India".

As T.S. Anantharaman, Financial Analyst, mentioned, "The savings and investments scenario in our country has undergone total change in the past decade, since the country embarked on a course of liberalization and globalization of its economy. With the increasing sophistication of our economy, the variety and type of investments options available to us today have multiplied. Also, with the economy getting more and more integrated with the world economy, rapid changes in the options, instruments, rate of return *etc.* have become the order of the day." Such a change is visible in respect of shares, mutual funds, fixed income, bank deposits, life insurance, pension plans *etc.* Since change and innovation is involved in this process, one can legitimately expect an exciting and lucrative career scenario in the banking, finance and insurance sector.

Electronic Banking:

Now with the advanced technologies setting trends in the banking sector, most banks are increasingly opting for the mode of Electronic Banking, the reason being that the technology enables the bank to be easily accessible to a large number of consumers and that too at a very low cost. Further, Electronic Banking or Banking facilitates the banking operations much faster than the traditional method.

"To most people, electronic banking means 24 hour access to cash through an Automated Teller Machine (ATM) or pay cheques deposited directly into savings accounts. Electronic Banking, also

known as Electronic Fund Transfer (EFT), uses computer and electronic technology as a substitute for cheques and other paper transactions. Many financial institutions use an Automated Teller Machine (ATM) card and a personal identification number (PIN) for this purpose.

On online banking advantages, he further pointed out, "In general, you will find lower fees and higher interest rates for deposits due to the reduced cost of operating online and no need for numerous physical bank branches. You will have easy access to account information and transactions, due to the fact that any internet enabled computer can become your bank terminal. You will generally have up to the minute current bank account information due to the automation of most systems. In many cases, online banks offer free bill pay, which can be a big saving in both money and time. You can transfer funds electronically between accounts. Since online banks are marketing for new customers, there are many special offers available. Some US banks offer initial amount of say \$20 to open your first account with them and some offer free overdraft protection on their interest checking accounts with a minimum balance."

Moreover, in improvement in the quality of services, the development and use of communication networks have also helped the banking industry to a larger extent. The design, management and regulation of electronically based payments system are becoming focus of policy deliberations.

According to Chairman and MD, Dr. K. Ramakrishna, "When you speak of inclusive growth, the human force of banking is essential. In the last 10 to 15 years, technology has become a big component. A human force is always needed. While that is so, convenience is essential too. With 24 hours banking and all other delivery channels such as ATM's and concepts such as e-banking, things have become very easy. But even in the long run, I can't see the importance of brick-n-mortar and human interaction changing in India.

For example, we see the very human and personal aspect of credit counselling coming to our country in a big way. Moral and

emotional support is an often unseen but important aspect of banking. People in banking do have to have great personal values. That does not come to light in a big way, as bankers don't showcase all that and generally talk numbers. But then, values are the core of this profession. Ethical banking is the core.

In our country after a slow start, there has been an explosive growth in mobile phones with its number reaching 80 million now, growing at the rate of more than three million per month. The mobile handset has emerged as an inevitable accessory not only for communications, but for entertainment, doing online transactions which include banking as well.

Driven by competition and transaction cost control, banks have been effectively embracing the mobile technology to add value to their customers. To attract new business and sustain customer loyalty, bank should be able to reach them through convenient delivery channels. The Internet banking was one of the true anywhere, anytime channels introduced by most of the banks. However, it needs a web connection to access the website of the bank and do transaction. As against this, mobile banking was found much more easy and convenient to use by the customers. Current estimates show that about 5 million customers using mobile banking in India.

Banking Industry (Vision 2020) :

Consequent to nationalization in 1969 and economic liberalization in 1991, banks in India are on fast track growth in size, technology and deliverables to customers.

Every aspect of banking will be transformed by new technology by 2020. Customer friendly products, delivery channels, relationship banking, dependency on IT systems and competitive pricing would be the driving forces, but a pressure cooker atmosphere cannot be avoided. The most successful institutions will be those that combine visionary technology and very competitive pricing with strong relationships and brands built on trust with previous in-depth experience of the client business. Banks would have adopted the following strategies to move to hi-tech banking as a necessity of e-commerce, e-banking *etc.* :

- (a) Identification of select branches from out of the entire spread of the branch network to provide innovative services.
- (b) In the scenario of severe competition and escalating expectation of the customers for newer products and improved as well as alternative delivery channels, die nerve center of banking will be redefined.
- (c) The key to survival of banks, therefore, is retention of customer loyalty by giving value added services tailored to their needs, using state-of-the-art technology, instead of relying on outdated practices
- (d) With the identified select number of branches for creating hi-tech banking, an ideal centralized solution can be considered. A countrywide network of computers could offer banking products to select corporate clients and high net worth individuals
- (e) Needless to say, flawless security and seem-less integration of operations through untiring efforts of employees and cohesive support from the management would be the key factors that will enable banks to make successful inroads into enabled 'New Age' banking.
- (f) Once the centralized topography is put in place, the infrastructure required for e-banking and e-commerce (with the necessary security) can be built to give state-of-the-art innovative services.
- (g) Flexi-work atmosphere with banking officials working out of their homes, without the need to go to offices, may be put in place. Instead of intra-bank cross country transfers, there may be inter-bank movement of senior officers in the public sec for domain, if at all it remains so.
- (h) Allocation of capital for each product/service and also borrower-wise capital allocation, as far as credit, market and operational risks are concerned, through sophisticated risks management techniques.
- (i) All performance measurements shall be risk-adjusted, as Risk Adjusted Performance Measurement (RAPM) plays a

key role in assessing the effectiveness. Risk-adjusted salary packages cannot be ruled out.

- (j) In the case of settlement in the retail segment, extensive use of debit card by the public and acceptance by merchant establishments would replace cheque cutting habit of customer, as currency/paperless financial deals would dominate.

There is no way banks can remain lukewarm in their attitude and lackadaisical in their approach to hi-tech banking and yet hope to grow. It is clearly a choice of either survival or extension, and that which survives would provide core commercial activity, instead of providing just financial services. The internet would be the engine of the banking revolution in the decade to come, and e-commerce its fuel. An April 2005 survey by the IAMAI indicates that the total value of e-business in India could grow from Rs. 570 crore in 2004-2005 to Rs. 2300 crore by 2006-2007. As e-commerce would involve banking facilities, one can imagine how much turn over would be put through the banking system Business to Business (B2B) involving business organisation as buyer and seller; Business to Consumer (B2C) involving customization of business would all pave way for a radical change in the banking habits of the Indian consumer. K-commerce through client and server and M-commerce through mobile agent would fuel the change in banking requirements. Companies need visionary leadership; mere management skills are not enough.

What's the point of managing people and products well- but in the wrong direction? Visionaries in large organizations are often marginalized because by definition they are constantly challenging fundamental assumptions about the future. It is better to bring forth the vision, and infuse fresh and independent thinking. Quality people often need more than money to relocate themselves. Nearly four decades ago, man landed on the moon. Within a decade and a half from now, perhaps man can avail of banking services there, if the exponential technology boom both in the art and science of banking can be taken as an indicator.

Banks in India

Reserve Bank of India :

Reserve Bank of India was established on April 1, 1935, with the basic objective to 'regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

Functions of RBI: It formulates and administers monetary policy and also performs a variety of developmental and promotional functions. It also handles the borrowing programme of the Government of India.

The bank functions as the banking and financial operation of the government, and tenders advice to it on economic matters in general and on financial problems in particular. The bank advises the government on public debt management and personalizes the government borrowing programmes.

The bank also acts as an agent of the government in respect of India's members of the International Monetary Fund. It exercises control over payments and receipts arising from international financial transactions under current and capital accounts and regulates the flow of foreign exchange for sub-serving the object of control of current account deficit.

Monetary Regulation : The main function of the Reserve Bank, as of all the other central banks is to formulate and administer monetary policy. Monetary policy refers to the use of instruments within the control of the central bank to influence the level of aggregate demand for goods and services by regulation of the total money supply and credit. The total expansion of money supply depends on the creation of high powered money (reverse base) and the multiplier action upon it. Through the various instruments available, the Reserve Bank seeks to control both dimensions of money supply change.

Commercial Banking System :

Commercial Banks are an important part of the financial system of the country. They offer a full range of services for individuals,

business and the government. Investment banks help companies and governments in issuing securities, help investors purchasing securities and trade securities, managing financial assets, and providing financial advice. The latest addition to banking services is the selling of insurance through a bank's established distribution channels, termed bank assurance.

The commercial banks as a group form the preponderant part of the organized banking system. These banks fall into four classes based on their method of establishment and the pattern of ownership. These four classes are:

- Banks in the public sector
- Banks in the private sector
- Foreign banks and
- Regional Rural banks

Public Sector Banks : There are in all 27 banks in the public sector, comprising the State Bank of India and its 7 associate banks viz. State Bank of Patiala, Travancore, Hyderabad, Bikaner and Jaipur, Mysore, Indore and Saurashtra, 14 commercial banks in the private sector nationalised in July 1969, and 6 more commercial banks nationalised in April 1980. (One public sector bank, New Bank of India was merged with Punjab National Bank in September 1993). The State Bank of India is the largest commercial bank. It has close association with the Reserve Bank and by virtue of being the Bank's principal agent, it has been entrusted with the conduct of government business at a number of its branches. The State Bank has delegated the agency functions to some of the branches of its seven associate banks.

Private Sector Banks : The banks in the private sector are classified into two categories, (i) the old private sector banks which are essentially regional in character. The second category are new private sector banks set up after 1991 (in the wake of financial sector reforms).

Foreign Banks : Foreign banks specialise in the financing of foreign trade and international banking. They also cater for the

needs of internal trade and industry and to that extent form an integral part of the domestic banking system.

Regional Rural Banks : The Regional Rural Banks which are State-sponsored, regionally based and rural oriented commercial banking institutions appeared on the Indian banking scene in 1975. Commercial banks have been involved closely in the setting up of and provision of capital, grant of financial accommodation and extension of organisational support to the Regional Rural Banks established by them.

Scheduled Banks and Non-Scheduled Banks : Another classification of banks which is in common usage is that of scheduled banks and non-scheduled banks which came into existence with the coming into force of the Reserve Bank of India Act. Let us find what do these two terms connote.

Scheduled banks are the banks which are included in the Second Schedule to the Reserve Bank of India Act and may be broadly compared to the member banks in the United States of America. According to Section 42(6)(a) of the Act a bank must meet the following 'conditions to qualify for inclusion in the Second Schedule:

- (i) The bank must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs,
- (ii) It must satisfy the Reserve Bank that its affairs are not being conducted in a manner detrimental to the interests of its depositors, and
- (iii) It must be a company as defined in the Companies Act 1956, or a State Cooperative bank or an institution notified by the Central Government in this behalf or a corporation or a company incorporated by or under any law in force in any place outside India.

By an amendment of the Act, the State Cooperative banks became eligible for inclusion in the Second Schedule from March 1966. Every Regional Rural Bank which is established under the Regional Rural Banks Act is included in the Second Schedule from the date of its establishment on its being notified by the Central Government in

pursuance of sub-clause (iii) of Section 42(6)(a). The status of scheduled bank confers on banks certain advantages, especially the facility of obtaining accommodation in the form of refinance and loans and advances from the Reserve Bank and of being considered for grant of authorized dealer's license to handle foreign exchange business (for which other conditions have also to be fulfilled). Correspondingly, they bear certain obligations towards the Reserve Bank such as maintenance of cash reserves and submission of fortnightly returns prescribed from time to time under Section 12 of the Reserve Bank of India Act, 1934. The Reserve Bank is empowered to exclude from the Schedule any bank the aggregate value of whose paid-up capital and reserves falls below Rs. 5 lakhs, or which goes into liquidation or otherwise ceases to transact banking business.

Non-Scheduled banks are banking companies other than those included in the Second Schedule to the Reserve Bank of India Act.

Indian Banks Abroad : Spread over more than 12 countries, Indian banks abroad specialise in various areas of international banking including financing of foreign trade. They cater to the needs of Indian exporters and importers and to that extent, they form an integral part of the domestic banking system. Besides these branches, Indian commercial banks are having representative offices in USA, Brazil, Indonesia, Iran, Egypt, Russia, Italy, Zimbabwe, China, Uzbekistan, Philippines and Vietnam. Indian commercial banks are also having wholly-owned subsidiaries and joint ventures in USA, Canada, Zambia, Nigeria, Uganda, Bhutan, Mauritius, Kenya and Nepal.

Industrial Development Bank of India :

Industrial Development Bank of India (IDBI), established under the Industrial Development Bank of India Act, 1964, is the principal financial institution for providing credit and other facilities for development of industry, coordinating working of institutions engaged in financing, promoting or developing industries and assistance to large industrial concerns and also helping small and medium industrial concerns through banks and state-level financial institutions.

Small Industries Development Bank of India :

The Small Industries Development Bank of India (SIDBI) was established as a wholly-owned subsidiary of the Industrial Development Bank of India (IDBI) as the principal finance institutions for promotion, financing and development of industries in the small scale sector. SIDBI started its operations from 2 April 1990 and is engaged in providing assistance to the small-scale industrial sector in the country through other institutions like State Financial Corporations, Commercial Banks and State Industrial Development Corporation.

Export-Import Bank of India :

Export-Import Bank of India (Exam Bank) was established on 1 January 1982 for financing, facilitating and promoting foreign trade in India.

Industrial Credit and Investment Corporation of India Limited (ICICI):

Industrial Credit and Investment Corporation of India (ICICI) was established in 1995 as public limited company to encourage and assist industrial units in the country. Its objectives, inter alia, include providing assistance in the creation, expansion and modernization of industrial enterprises, encouraging and promoting participation of private capital both internal and external, in such enterprises, encouraging and promoting industrial development and helping development of capital markets. It provides term loans in Indian and foreign currencies, underwrites issue of shares and debentures, makes direct subscriptions to these issues and guarantees payment of credit made by others.

National Housing Bank :

National Housing Bank (NHB), a wholly owned subsidiary of the RBI, is an apex body to finance the housing sector in India. Set up in 1987 under the National Housing Bank Act, 1987, started its operation from July 1988. The main objective of the Bank is to extend financial assistance to various eligible institutions in the housing sector by way of refinance and direct finance.

National Bank for Agriculture and Rural Development (NABARD):

It was set up in 1982 under an Act of the Parliament by merging the Agricultural Credit Department and Rural Planning and Credit Cell of Reserve Bank of India (RBI) and the entire undertaking of Agricultural Refinance and Development Corporation (ARDC).

Credit functions: NABARD provides different types of refinance (Short-term Medium-term and Long-term) to the eligible institutions. **Conversion & Rescheduling facilities:** NABARD provides refinance to eligible institutions, normally SCBs and RRBs for conversion and rescheduling of loans under conditions of drought, famine or other natural calamities, military operations, enemy action *etc.* Similar facilities are also available in respect of loans made to artisans, small-scale industries *etc.*

Conversion & Rescheduling facilities: NABARD gives refinance to eligible institutions, normally SCBs and RRBs for conversion and rescheduling of loans under conditions of drought, famine or other natural calamities, military operations, enemy action *etc.* Similar facilities are also available in respect of loans made to artisans, small-scale industries *etc.*

Financing cottage/village/small-scale industries, etc.

- Coordinates operations of rural credit institutions.
- Ensures institution-building to improve absorptive capacity of the credit delivery system.
- Develops expertise to deal with agricultural capacity of the credit delivery system.
- Assists government, RBI and other institutions in rural development efforts.
- Provides facilities for training and research and dissemination of information in rural banking and development.
- Assists State Governments to enable them to contribute to the share capital of eligible institutions.
- Provides direct loans in cases approved by Central Government.

Regulatory Functions: The Banking Regulation Act, 1949, empowers NABARD to undertake inspection of RPBs and cooperative banks (other than primary cooperative banks). Any RPB or cooperative Bank seeking permission of RBI for opening branches, etc. will have to obtain the recommendation of NABARD.

Ultimate Beneficiaries: While all funds are routed through the SLDBs/ SCBs/CBs/RRBs by NABARD, the ultimate beneficiaries of investment finance can be individuals, partnership concerns, companies, state-owned corporations or cooperative societies. The ultimate beneficiaries of production credit are generally individuals who are members of primary credit institutions.

Promotional Role: NABARD plays a vital role in the reduction of regional imbalances and providing assistance to small farmers, marginal farmers and other weaker sections. It pays special attention to explore new and innovative investment opportunities in agriculture and rural development.

Research and Development Fund: NABARD maintains a R&D Fund for supporting research cum action oriented projects in the field of rural development. The fund assists the SLDBs/RPBs to build up their technical capabilities Apart from annual contributions to the funds out of NABARD' profits, the fund is further supplemented by gifts, grants, donations, etc. which NABARD gets for the purpose from various sources.

Cooperative Development: NABARD has set up a Cooperative Development Fund for supporting the efforts for the ground level credit institutions and also CCBs for deposit mobilisation, human resource development, building up better MIS, computerization and conducting special studies for improving functional efficiency.

Asian Development Bank :

The Asian Development Bank (ADB), an international partnership of 63 member countries, was established in 1966 with its headquarters at Manila, Philippines. India is a founder member. The Bank is engaged in promoting economic and social progress of its developing member countries in the Asia and the Pacific region. Its principal functions are as follows: (i) to make loans and equity

investments for the economic and social advancement of its developing member countries; (ii) to provide technical assistance for the preparation and execution of development projects and programs and advisory services; (iii) to respond to the requests for assistance in coordinating development policies and plans in developing member countries; and (iv) respond to the requests for assistance coordinating development policies and plans of developing member countries.

International Monetary Fund :

As part of its mandate for international surveillance under the Article of Agreement, the IMF conducts what is known as Article IV consultations to review the economic status of the member countries, normally, once a year Article IV consultations are generally held in two phases. During this exercise, the IMF mission holds discussions with RBI and various ministries/Department of Center Government. The Article IV consultations are concluded with a meeting of IMF Executive Board at Washington D.C. which discusses the report. The first phase of 2004 Article IV consultations was held in November 2003. After that another visit was made by the IMF mission to India in March 2004 for making some interim assessment about the macro-economic and monetary development situations for the purpose of world Economic Outlook Report.

□□□

CHAPTER



BANKING REGULATION ACT-1949

Banking is a service industry. As against the other professions, the large portion of the working capital, of the banks, comes from the depositors and not from the shareholders. The right of management of the banks rests mostly in the hands of the small number of shareholders and the depositors have no right to take part in management. Thus, for the safeguard of the interests of the depositors some arrangement must be made by the central government. This arrangement should be done in such a way that the banks may not misuse the money of the depositors and the depositors may not have any apprehension or doubt of losses for their deposited money. There has been a rapid development of the banking facilities for the last so many years and majority of the people have started opening their accounts in the banks and have started using cheques for payments. Thus, it is imperative to have a statutory control over the credit policy of the banks and their other activities towards the use of the available resources, because whenever a bank fails, people loose confidence in the banking system. The government, thus, formulates such laws or gives such rights to the Central Bank so that the functioning of the banking system may be very smooth. In short, the control and regulation policy of the banking system is adopted with the purpose to check

bank-failures and their unbalanced development. In an underdeveloped country like India, the banking regulation is enacted to bring a co-ordination between the indigenous banks and the organized banks.

Need for Banking Act in India :

The need for the enactment of the banking legislation in India has been felt due to the following reasons:

(1) ***Failure of the Banks*** : History of banking development in India shows that many banks had failed. Prabhat Bank and Laxmi Bank are prominent examples in this connection. Continuous failure of the banks earned confidence of the public in the banking system, this also brought many hurdles in the development of banking in the country. Thus, the necessity of banking legislation was urgently felt so as to bring confidence of the people in the banking system, to check the further failure of the banks and to pave the way for the sound development of the banking system in the country.

(2) ***Un-balanced and Unequal Growth of Banks*** : Growth of commercial banks in India has also remained unbalanced and unequal. Banking activity has remained confined mostly to big cities or industrial centers. New branches were also opened in these areas. Rural areas habituating the bulk of India's population have received a very limited banking service. Thus for the balanced and equal growth of banks, banking legislation was imminent.

(3) ***Lack of Developed Bill Market in India*** : A developed bill market is also a pre-condition for a developed banking activity in the market. However, it is rather unfortunate that the bill market, along with money market and capital market, continued to be in its infant stage in India. As a result, the Indian industrialists were deprived of cheap credit facilities. Thus, the necessity of banking legislation was felt to develop an organized and well-coordinated bill market.

(4) ***Lack of Co-ordination between Indigenous Bankers and Organized Banks*** : Prior to the development of present banking system in the country, the indigenous bankers were very dominant. They used to advance loans not only for productive purposes but

also for unproductive purposes. This led to a severe competition between the indigenous bankers and the commercial banks instead of remaining in co-operation and co-ordination with each other. This brought an adverse effect on the development banking system in the country. Difficulty was also faced in credit control. Thus, the need of a banking legislation was a remedial step to bring co-ordination between these two competing institutions.

(5) **Insufficient Capital** : Many commercial banks in India used to operate with insufficient capital due to their low proportion of capital funds, which was just 1%. The commercial banks also had to offer high rates of interest to attract public savings. With a view to cover for high interest payments the banks used to invest their deposits in high-risking areas. Also in order to mobilize savings, these banks tended to increase their branches which were difficult to manage. Thus, banking legislation was needed to check all this and to fix minimum capital requirements.

(6) **To Make Monetary and Credit Policy More Effective** : The monetary and credit policy is framed and implemented by the Reserve Bank, but due to lack of effective banking legislation, there was no co-ordination and co-relation between these two policies. Thus, it was felt that the powers of the Reserve would only be effective, if through a banking legislation, appropriate control may be done on the policies of financial and banking institutions.

History of Banking Legislation in India :

The necessity of banking legislation was felt during the time of banking crisis in 1913-14, when many banks failed. The people and the economic thinkers then opined that if had there been any legislation regarding the regulation of banking organisation, then Indian banks could not have involved in such irregularities. Thus, emphasis was laid on the banking legislation, but the government took no action in this direction.

In 1929, when **Central Banking Enquiry Committee** was appointed, it was asked to give suggestions regarding the regulation of banking system in our country the interest of the people. The Committee, in its report, emphatically said that such statutory laws were required to bring stability in the banking system which may

establish a control on the operating, auditing and supervising activities of the banking system. On the recommendations of this Committee some extra sections were added in the Indian Companies Act 1913, which also included some rules regarding the operation and organisation of banks.

In 1934, Reserve Bank of India Act was passed and thereby the Reserve Bank was established. In 1939, the Reserve Bank suggested the Government of India to formulate a separate banking legislation to regulate the banking system in our country and also prepared a draft of the Banking Bill. But the government could do nothing in this direction due to remaining busy in the problems related due to the out break of second World War.

In 1943-44, the Companies Act was again amended and the Reserve Bank was given more powers to control and regulate the commercial banks in our country. In 1946, the government of India again issued an ordinance by which the Reserve Bank was given more comprehensive powers. The Reserve Bank was empowered to expel any scheduled bar; from the list if it neglects Its ordinance.

After gaining independence, the popular government felt the necessity of an independent banking legislation for the healthy development of banking system in our country. Thus on March 16, 1949 the Banking Companies Act was passed to consolidate and amend the law relating to the Banking Companies. With effect from 1.3.1966 the name of the Act has been changed to Banking Regulation Act, 1949. The Act deals with banking companies and corporations and does not purport to codify the law of banking. It is mainly a regulatory Act, meant to regulate the functioning of banking companies and corporations.

Salient Features of the Banking Regulation Act, 1949 :

The following are the main features of the Banking Regulation Act :

(1) *Objectives* : The Act was passed with the following major objectives in view:

(i) *Comprehensive Legislation* : The Indian Companies Act, 1913 was inadequate and unsatisfactory to regulate and control

the business of banking in India and therefore, there was a need to have specific legislation containing comprehensive provisions, particularly to the business of banking in India.

- (ii) *To Prevent Bank Failures*: The bank failures were common in those days due to inadequacy of capital and hence minimum capital requirements was necessary. The Act was enacted to prevent such bank failures by certain minimum capital requirements.
- (iii) *To Avoid Cut Throat Competition* : The Act passed aims for avoiding cut throat and wasteful competition among the banking companies. The Act also regulates the opening of branches and changing the location of the existing branches.
- (iv) *Ensuring Balanced Development of Banks* : In order to avoid indiscriminate opening of new branches and thereby ensuring balanced development of banking companies, the system of licensing is provided in this Act.
- (v) *Regulation of Bank Credit and Working of Banks* : The RBI has been given powers to approve the appointment, re-appointment and removal of the Chairman, directors and officers of the banks. This will ensure efficient and smooth working of banks in India.
- (vi) *Safeguarding the Interests of Depositors* : The Act protects the interests of the depositors and the public at large by incorporating certain provisions such as prescribing cash reserves and liquidity ratios. This would enable the banks to meet the demand of the depositors.
- (vii) *Strengthening the Banking System* : This Act provides for compulsory amalgamation of weaker banks with stronger ones to facilitate strengthening the banking system of the country.
- (viii) *Controlling Foreign Banks* : The Act contains certain provisions which restrict the foreign banks to invest funds of the Indian depositors outside India.
- (ix) *Providing Quick and Easy Liquidation* : The Act also provides for quick and easy liquidation of the banks if they are not able to continue further or amalgamate with other banks.

The Banking Regulation Act, 1949 as amended up to date is divided into five parts and contains five schedules. This Act is applicable to all banking companies including co-operative banks. The provisions of this Act provide for achieving the above mentioned objectives for which the Act was enacted.

(2) *Scope of Banking Regulation Act* : As per Section 2 of the Act, after the enactment of the Act, the provisions related to the Banking institutions as given in the Indian Companies Act, 1956 will be applicable to the banking institutions. Besides this, various sections of Act will not be contrary or adverse to the Indian Contract Act, The Indian Negotiable Instruments Act. The Civil and Criminal Procedure Code and the Bankers Books Evidence Act. The places where the Act is silent, the provisions of the above Acts will be applicable there.

(3) *Main Provisions of Banking Regulation Act are :*

- Part - I : Preliminary Sections, From Section 1 to 5-A.
- Part - II : Business of Banking Companies, From Section 6 to 36-A.
- Part - IIA : Control and Management, From Section 36 AA to 36 AB.
- Part - IIB : Prohibition of Certain Activities in Relation to Banking up to Section 36 AD.
- Part - IIC : Acquisition of the undertaking of Banking Companies in certain cases, From Section 36 AE to 36 AJ.
- Part - III : Suspension of Business and Winding up of Banking Companies, From Section 36B to 45.
- Part - IIIA : Special Provision for speedy disposal of Winding up proceedings, From Section 45A to 45X.
- Part - IV : Miscellaneous Provisions, From Section 46 to 55.
- Part - V : Main Provisions as applicable to Co-operative Banks Section 56.

The Banking Regulation Act, was applicable to all the companies doing banking business in our country before 18th July,

1969. With effect from 19.7.1969, the Banking Companies (Acquisition and Transfer of undertakings) Act, 1970 came into force. It nationalised the 14 major Indian Banks by providing that the whole of the undertakings of those banks shall be taken over by and become vested in 14 corresponding new corporate, bodies established under that Act. These newly constituted corresponding banks now function in the public sector. The 14 old banking companies whose undertakings are thus taken over by the Government are free to carry on any business, if they wish to, out of the compensation payable to them under the Act.

Major Provisions of the Act :

The important provisions of the Banking Regulation Act, 1949 are as under:

(1) **Definition of Banking Company :** According to the Section 5(c) of the Act. "Banking company means any company *which transacts the business of banking in India.*" The Section 5(c) Clause (b) defines "Banking Company" and says that "Banking means *the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and with draw able by cheque, draft, order or otherwise.*"

Section 7 of the Act, as amended in 1963, says that every banking company, doing banking business, has to use any of the words 'bank', 'banking' or 'banking company' along with their name, but at the same time the Act prohibits to use any of these names to a company other than banking company, or firms, individuals or group of individuals.

(2) **Banking Business :** Section 6 of the Act provides for the form of business in which banking companies may engage. The forms of business specified are in consonance with the accepted banking principles, such as borrowing or advancing of money; discounting, buying, selling, collecting and dealing in bills of exchange, promissory notes, drafts *etc.*; underwriting and dealing in stocks, funds, shares, debentures *etc.*; purchasing and selling of bonds; acting as an agent for any Government or any other person; contracting for public and private loans; underwriting and executing trusts; acquiring and undertaking the business of any

company; granting and issuing letters of credit; travellers cheques *etc.*; buying and selling of foreign exchange; providing locker or safe-deposit facilities *etc.*

This section prohibits the banking companies from taking part in trading and speculative activities thereby landing themselves in danger.

(3) Management of Banks : Section 10 of the Act provides that No Banking Company (a) shall employ or be managed by a managing agent; or (b) shall employ or continue the employment of any person — (i) who is, or at any time has been, adjudicated insolvent, or has suspended payment or has compounded with his creditors, or who is, or has been, convicted by a criminal court of an offence involving moral turpitude; or (ii) whose remuneration or part of his remuneration takes the form of commission or of a share in the profits of the company; (c) shall be managed by any person (i) who is a director of any other company; or (ii) who is engaged in any other business; or (iii) whose term of office as a person managing the company is for a period exceeding five years at any one time.

According to Section 10A, not less than 51% of the total number of members of the Board of Directors will include persons with professional and other experience in respect of one or more of the following subjects *viz.* accountancy, agriculture and rural economy, banking, co-operation economics, finance, law, small-scale industry, *etc.* and any other matter, the special knowledge, and practical experience in, which would, in the opinion of the Reserve Bank, be useful to the banking company.

Section 16 of the Act says that no banking company shall have as a director in its Board of Directors any person who is a director of any other company. Section 10-B, says that banking is to be managed by the whole time Chairman, he shall hold office for such period not exceeding five years but shall be eligible for re-election or reappointment.

Banking Laws (Amended) Act, 1983, empowers the Reserve Bank to appoint any person as chairman of a banking company when the office of its chairman remains vacant for a long time and when the interests of the said banking company are likely to be adversely affected by the said office so remaining vacant.

(4) **Paid-up Capital and Reserve** : Section 11 of the Act, lays down the requirements regarding the minimum standard of paid up capital and reserves as a condition for the commencement of business.

Requirements of Aggregate Value of Paid-up Capital and Reserve

Area		Aggregate Paid-up Capital and Reserve
A.	I. Incorporated in India	(Rs.)
	(i) For a banking company incorporated in India having places of business in more than one state.	5,00,000
	(ii) If any such place or places of business is or are situated in the City of Mumbai or Kolkata or both	10,00,000
B.	If all places of business in one state but none of which in Mumbai City or Kolkata:	1,00,000
	(i) For principal place of business in one state (except) in City of Mumbai and Kolkata) Plus	10,000
	(ii) For each other place of business in the same district. Plus	25,000
	(iii) For each place of business situated outside that district Subject to total of	5,00,000
	(iv) For having only one place of business	50,000
c.	If all places of business in one State:	
	(i) One or more of which is / are in the city of Mumbai or Kolkata plus	5,00,000
	(ii) In respect of each place of business situated outside the city of Mumbai or Kolkata	25,000
	Subject to total of	10,00,000
	II. Incorporated Outside India	
	(i) If it has no place of business in Mumbai City or Kolkata	15,00,000
(ii) If it has a place of business in Mumbai City or Kolkata or both	20,00,000	

Note: Banking Companies incorporated **outside India** have to deposit the amount required as above either in cash or in unencumbered approved securities or partly in cash and partly in such securities with the Reserve Bank of India.

According to the provisions of **Section 12**, the subscribed capital of the company is not less than half of its authorized capital, and

the paid-up capital is not less than half of its subscribed capital. According to **Section 14**, no banking company shall create any charge upon its unpaid capital, and any such charge, if created shall be invalid.

(5) **Restrictions on Distribution of Dividends** : **Section 15** of the Act lays down that no dividends shall be paid by any banking company until all its capitalized expenses have been completely written off. However, it can pay dividends on its shares without writing off: (i) The depreciation, if any, in the value of its investments in approved securities, (ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities); (iii) the bad debts, if any, in any case where adequate provision has been made to the satisfaction of the auditor of the banking company.

(6) **Check on Interlocking of Directors** : Interlocking directorates which pave the way of mismanagement are prohibited under the Act. According to **Section 16** of the Act, no banking company incorporated in India shall have, any person as director who is a director of another banking company.

(7) **Voting Rights** : The maximum voting rights of anyone shareholders is fixed by the Act, as amended in 1994, at 10 percent of the total voting rights. This controls the concentration of power in any banking company in the hands of the few shareholders.

(8) **Reserve Fund** : **Section 17** of the Act, as amended in 1962, requires every banking company, incorporated in India, to transfer its reserve fund a sum equivalent to not less than 20 percent of its profits irrespective of whether or not its reserves have equalled the paid-up capital **Section 17(2)** laws down that where a banking company appropriates any sum from the *reserve* fund, it shall within 21 days from the date of such appropriation, report the fact to the Reserve Bank explaining the circumstances relation to such appropriation. Reserve Bank may in any particular case, extend the said period of 21 days or condone any delay in the making of such report.

(9) **Cash Reserves** : **Section 18** lays down that every banking company, not being a scheduled bank, shall maintain by way of

cash reserve with itself or by way of balance *in a* current account with the Reserve Bank or by way of a net balance in current accounts, a sum equivalent to at least **3 percent of the total of its demand and time liabilities** as on last Friday of the second preceding fortnight. It shall submit to the Reserve Bank before the 20th of every month a return showing the amount so held on alternate Fridays during a month. Here it may be added that the Reserve Bank may increase the above said rate, *i.e.*, 3% but so as not to exceed 15% of the total demand and time liabilities.

(10) Restrictions on Loans and Advances : According to Section 20 of the Act, no banking company shall (a) grant any loans and advances on the security of its own shares, or (b) enter into any commitment for granting any loan or advance to or on behalf of (i) any of its directors, (ii) any firm in which any of its directors is interested as partner, manager, employee or guarantor or (iii) any individual in respect of whom any of its directors is a partner or guarantor.

(11) Control on Loans and Advances : The Reserve Bank has the power to control advances by banking companies. Under provisions of Section 21, the Reserve Bank has been empowered to determine the policy in relation to advances to be followed by banking companies in the interest of public. The Reserve Bank in particular may give directions to banking companies, either generally or particularly, as the purpose for which advances may or may not be made, the margins to be maintained in respect of secured advances *etc.* Selective Credit Controls are imposed by the Reserve Bank under this section.

(12) Licensing of Banking Companies : Section 22 of the Act lays down that no company shall carry on banking business unless it holds a license issued by the Reserve Bank of India. Reserve Bank can also refuse to issue the license. Before granting any license, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that the following conditions are fulfilled :

- (i) that the company is in a position to pay its present or future depositors in full as their claims accrue;

- (ii) that the affairs of the company are not being conducted in a manner detrimental to the interests of its present or future depositors;
- (iii) that the company has adequate capital structure and earning prospects.
- (iv) that the public interest will be served by the grant of a license to the company to carry on banking business in India.

Before giving any license to a company incorporated outside India, the Reserve Bank may require that (a) the above conditions are fulfilled, (b) carry on business will be in the public interest, (c) the law of the country does not indiscriminate in any ways against banking companies registered in India and (d) the company complies with all the provisions of this Act to the banking companies incorporated outside India.

Reserve Bank may **cancel a license** (i) if the company ceases to carry on banking business in India or (ii) if the company at any time fails to comply with any of the above mentioned conditions. But before the cancellation of the license the Reserve Bank will give an opportunity to the company to explain its conduct.

(13) Opening and Transfer of Branches : Under the provisions of **Section 23**, the Reserve Bank has been empowered to control the opening of new and transfer of existing places of banking companies as follows:

- (1) Without obtaining the prior permission of the Reserve Bank:
 - (i) no banking company shall open a new place of business in India or change otherwise than within the same city, town or village, the location of existing place of business; and
 - (ii) no banking company incorporated in India shall open a new place of business outside India or otherwise than within the same city, town or village in any country or area outside India, the location of an existing place of business situated in that country or area. However it can open its branch for a period not exceeding one month of a temporary place of business within a city

where it has already a branch for the purpose of banking facilities to the public on the occasion of an exhibition, a conference or a mela or any other like occasion.

- (2) Before giving permission, R.B.I. may require to be satisfied as to the (a) financial condition and history of the company, (b) the general character of its management, (c) the adequacy of its capital structure and earning prospects and (d) that public interest will be served by the opening or change of location of the place of business.

(14) Minimum Liquid Assets Ratio : Section 24 of the Act as, amended in 1962, requires every banking company to maintain in gold, cash or unencumbered securities, valued at a price not exceeding current market price an amount not less than 25 percent (now 40 percent) of its total demand and time liabilities. This provision is intended to ensure the liquidity of the assets of the banks. This section is especially important since one of the main reasons which led to a number of bank failures in the past had *been* the negligence on the part of the bankers to maintain the liquidity of their assets in their greed to earn more profits.

(15) Property in India : According to the Section 25 of the Act, the foreign banks carrying on business in India must have assets in India at the close of business on the last Friday of every quarter should not be less than 75 percent of their demand and time liabilities. Its main purpose is to check the flow of Indian capital to foreign countries. Further every banking company is required to submit in the prescribed form to Reserve Bank within one month from the end of every quarter a return showing its assets and time and demand liabilities in India.

(16) Submission of Returns : According the provisions of Section 27 every banking company shall, before the close of the month succeeding that to which it relates, submit to the Reserve Bank a return in the prescribed form and manner showing its assets and liabilities in India as at the close of business on the last Friday or every month.

Section 26 lays down that every banking company shall, within 30 days after the close of each calendar year, submit a return to the Reserve Bank all accounts in India which have not been operated upon for ten years. If money is deposited for a fixed period, the said term of ten years shall be reckoned from the date of the expiry of such fixed period.

(17) Annual Accounts and Audit : Section 29 lays down that at the expiration of each calendar year every banking company shall prepare a balance sheet and profit and loss account as on the last working day of the year. **Section 30** lays down that the above balance sheet and account shall be audited by a person duly qualified.

The Act requires that three copies of the balance sheet and accounts prepared under Section 29 together with auditor's report must be submitted to the Reserve Bank within three months from the end of the period to which they refer (**Section 31**), unless it is extended up to further period of 3 months by the Reserve Bank. Under **Section 32**, it is compulsory for every bank to file with the Registrar of Companies Three copies of its accounts and balance sheet and the auditor's report. Under **Section-33**, it is necessary for every foreign bank to keep a copy of its final accounts at such a place where every person may scrutinize it.

(18) Inspection : Section 35 lays down that the Reserve Bank may cause an inspection to be made by one or more of its officers of any banking company and its books and accounts and shall supply a copy of its report to the banking company. All books, accounts and other documents may be made available for scrutiny to the inspection officer. If directed by the Government, the Reserve Bank shall report to the Central Government, if it finds that the affairs of the banking company are detrimental to the interests of the depositors. The Central Government, after giving an opportunity to the banking company, can prohibit it from receiving fresh deposits and direct the Reserve Bank to apply under **Section 38** for the winding up of the banking company.

(19) Suspension of Business (Moratorium) : Section 37 of the Act gives that when a banking company is temporarily unable to meet its obligations it may apply to **High Court** praying for an order

staying the continuation of all sections and proceedings against it for a period not exceeding 6 months. Such suspension of business is generally called a **moratorium**. The High Court has the power to grant relief, even though a report is required from the Reserve Bank in this context.

In such cases, the Reserve Bank may apply to the **Central Government** for an order of moratorium (**Section 45**). On such an order being passed, the continuance of all actions and proceedings against the banking company are stayed for a specified period. During this period, the Reserve Bank may prepare a scheme for reconstruction of the company or its amalgamation with any other bank.

(20) Winding Up of a Banking Company : Sections 38 to 44 of the Act lay down the provisions for the winding up of a banking company. Under **Section 38**, the High Court has to order the winding up for a company if it is unable to pay its debts, or is under a moratorium and the Reserve Bank applies the High Court for its winding up on the ground that its affairs are being conducted in a manner detrimental to the interests of the depositors.

(21) Appointment of Liquidator and Payment to Depositors : Under **Section 38A** of the Act every High Court has a Court Liquidator who has to submit a preliminary report to the High Court within two months from the date of winding up order on the assets and liabilities of the banking company. He has also to give notices to preferential claimants and secured and unsecured creditors within 15 days of the winding up order. Under **Section 43** of the Act, every depositor shall be deemed to have filed his claim for the amount standing in its books to his credit and such claims shall be deemed to have been proved unless the liquidator shows that there is a reason for doubting its correctness.

After doing adequate provisions for preferential payments, the Liquidator shall pay within 3 months to every depositor of a Saving Bank Account a sum of Rs. 250 or his credit balance whichever is less in priority to all other debts. The remaining assets are thereafter utilized for the payments of debts on a *pro rata* basis.

A banking company cannot be voluntarily wound up unless the Reserve Bank certifies that it is able to pay its debts in full.

(22) Amalgamation of Banking Company : Section 44A of the Act lays down the procedure for amalgamation of a banking company with another. The scheme containing the terms of amalgamation is to be approved by a majority in number representing 2/3rd the value of the shareholders in a General Meeting. A dissenting shareholder is entitled to receive the value of his share as may be determined by the Reserve Bank. The Reserve Bank has to sanction the Scheme after the share-holders' approval. On such sanction the assets and liabilities of the bank are transferred to the acquiring bank. The Reserve Bank is empowered to order that the first bank be dissolved on a specified date.

(23) Power of Central Government to Acquire Banking Companies: Part IIC constituting **Section 36 AE to 36 AJ** was introduced in the Banking Regulation Act by the Amending Act 58 of 1968. It empowers the Central Government to acquire a Banking Company. **Section 36 AE** is the key Section. Its sub-section (1) reads:

(1) If on receipt of a report from the Reserve Bank, the Central Government is satisfied that a banking company :

- (a) has, no more than on one occasion, failed to comply with the directions given to it in writing under **Section 21 or Section 35A**, in so far as such directions relate to banking policy, or
- (b) is being managed in a manner detrimental to the interests of its depositors.

It is necessary to acquire the undertaking of such banking company, the Central Government, after such consultation with the Reserve Bank as it thinks fit, by notified order, acquire the undertaking of such company.

(24) Punishment For Certain Activities in Relation to Banking Companies : The Amendment Act has to be its Part IIB introduced a novel provision in the Act. A new **Section 36 AD** has been added, which reads:

(1) No person shall:

- (a) Obstruct any person from lawfully entering or leaving any office of business of a banking company, or

- (b) hold, within office any demonstration which is violent or which prevents the transaction of normal business by the bank, or
- (c) act any manner calculated to undermine the confidence of the depositors in the bank.

This Section is intended to prohibit bank employees from resorting to demonstrations and causing obstruction to the public while agitating for their demands related to their service conditions.

Conclusion : The Banking Regulation Act, 1949 with all its amendments is a landmark in the history of banking legislation in our country. Credit goes to the Central Government in general and the Reserve Bank in particular to implement this act very successfully in the country. The Act has provided a statutory control on the functioning of the banks and their development in the country. It has provided a new direction and stability to the banking institutions along with the framing of appropriate policies for the general public. Thus, it has created a confidence among the people in the banking system. This Act does not apply on the nationalised banks, a separate legislation has been passed for them.

Defects in the Indian Banking Legislation :

Although the Banking Regulation Act is a praiseworthy step to bring the banking system on sound footing and it has taken many steps to remove the faulty working of the banks in the country. Yet the following important defects are seen in the banking legislation:

(1) **Lack of Control on Indigenous Banks :** The Banking Regulation Act could not control the activities of the indigenous bankers, they still supply about 80 percent of credit and loans. These banks are still outside the jurisdiction of the Reserve Bank that is why the credit policy of the Reserve Bank could not be successful.

(2) **Lack of Control on Co-operative Banks :** Although separate Banking Regulation Act has been made applicable to certain co-operative banks, yet many other types of co-operative banks are entering the business field and are giving a tough competition to the commercial banks. The Act could not control such banks.

(3) *Lack of Proper Control on the Liquidity of Assets*: The critics of the Act are of the opinion that the Banking Regulation Act could not lay proper emphasis on the liquidity of assets. That is why there is no sufficient liquidity of the assets.

(4) *Unable to Check the Concentration of Banks in the Cities*: We find that most of the banking facilities are available in big cities and new branches too are concentrating in these cities. The banking legislation could neither check this concentration nor it could make the banking facilities available in small towns and villages.

(5) *Unable to Check the Indiscipline in the Bank Employees*: Although this Act has prohibited the violent demonstration of the bank employees, yet they still resort to demonstrations and strike. Many a time All Bank Employees Union has hampered the working of the banks which has caused a great inconvenience to the general public and the trading community.

Despite the above major defects, it is appropriate to comment that the banking legislation has done a commendable job in controlling the banks in the country. Here, it is necessary to say that 'Sound banking system does not depend on the soundness of the legislation but it depends on the bankers' themselves.

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CHAPTER



BANKER-CUSTOMER RELATIONSHIP

It is necessary to explain the legal meaning of the terms *banker* and *customer* before study of relationship between two.

Banker:

The functions of a commercial banker are so varied that it is difficult to give a satisfactory definition of the word banker. According to Macleod, "the essential business of a banker is to buy money and debts by creating other debts. A banker is, therefore, essentially a dealer in debts or credit."

The Hilton Young Commission asserts that "the term *bank* or *banker* should be interpreted as meaning every person, firm or company, using in its description or its title *bank* or *banker* or *banking* and every company accepting deposits of money subject to withdrawal by cheque, draft or order."

Section 3 of the Indian Negotiable Instruments Act, 1881, says that the word "banker includes any person acting as banker and any post office savings bank."

According to Section 2 of the Bill of Exchange Act, 1882, the word "banker includes a body of persons, whether incorporated or not, who carry on the business of banking."

Before 1949, there was no statutory definition of banking. The Banking Companies Act, passed in 1949, defines the term banking in Section 5 as follows:

“A banking company means any company which transacts the business of banking.” “Banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, payable on demand or otherwise, and withdrawable by cheque, draft or otherwise.”

According to Sir John Paget, “No person or body, corporate or otherwise, can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheques, and (iv) collect cheques, crossed and uncrossed, for his customers.” This definition points out the four major functions of the commercial banking business. Sir Johan Paget also lays emphasis on the performance of the above functions in a regular and recognised manner. According to him. “one claiming to be a banker must profess himself to be one and the public must accept him as such; his main business must be that of banking from which, generally, he should be able to earn his living.”

According the provisions of Section 6 of the Act, in addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely:

- (i) Borrowing, raising or taking up of money; lending or advancing money either upon or without security; drawing, making, ace discounting, buying, selling, collecting and dealing in exchange, hundis, promissory notes, coupons, drafts, bills of railway receipts, warrants, debentures, certificates, scrips am instruments, and securities, whether transferable or negotiable or not; grant or issue of letters of credit, transferable, scrips and circular notes; buying and selling and dealing in bullion and species; buying and selling foreign exchange, including foreign bank notes; acquiring, holding, issuing on commission, underwriting and dealing in stocks, funds, debentures, bonds, obligations, securities and investments of all kinds; purchasing and selling bonds, scrips, or valuables on

deposits or for safe custody or other wise; providing safe deposit vaults; collecting and transmitting of money and securities.

- (ii) Acting as agents for any government or local authority or any other person or persons; carrying on agency business of any description, including clearing and forwarding of goods, giving receipts discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or secretary or treasurer of a company.
- (iii) Contracting for public and private loans and negotiating and issuing them.
- (iv) Effecting, insuring, guaranteeing, underwriting, participate managing and carrying out of any issue, public or private, of municipal or other loans or shares, stocks, debentures, or debenture stock of any company, corporation or association, and keep money for the purpose of any such issue.
- (v) Carrying on and transacting every kind of guarantee and indemnity business.
- (vi) Managing, selling and realizing the value of any property which may come into its possession in satisfaction of any of its claims.
- (vii) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form a security or part of a security for any loan or which may be connected with any such security.
- (viii) Undertaking and executing trusts.
- (ix) Undertaking the administration of estates as executor, trustee or otherwise.
- (x) Establishing and supporting, or aiding in the establishment and support of, associations, institutions, funds, trusts, and conveniences created for benefit the employees or ex-employees of a company or the dependants or connections of such persons; granting pensions and allowances and

making payments towards insurance; subscribing to or guaranteeing money for charitable or benevolent purposes or for any exhibition or for any public, general or useful object.

- (xi) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purpose of a company.
- (xii) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part or parts of the property and rights of a company.
- (xiii) Acquiring or undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section.
- (xiv) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of a company.
- (xv) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

No banking company shall engage in any form of business other than the forms discussed to above.

Some of the above provisions were first inserted in the Indian Companies Amendment Act. 1936. The forms of business under the above provisions are, however, sufficiently comprehensive for a banking company and are in consonance with the accepted principles and practices of banking followed in industrially advanced countries.

Business Prohibited for a Banking Company :

Some provisions of the Banking Regulations Act 1949, prohibit banking companies from doing some type of business activities. According to Section 8 of Banking Regulation Act. 1949, a banking company cannot engage directly or indirectly in trading activities or undertake trading risks. No banking company can directly or

indirectly deal in buying or selling or bartering of goods or engage in any trade or buy, sell or barter goods for others. A banking company, however is permitted to do so for the following purposes:

- (a) to realise the securities given to it or held by it for a loan, if need arises for the realisation of the amount lent,
- (b) to buy or sell or barter for others in connection with (i) bills of exchange received for collection or negotiation, and (ii) undertaking the administration of estates as executor, trustee *etc.* For the purpose of this section 'goods' means every kind of movable property, other than auctionable claims, stocks, shares, money, bullion and specie and all instruments referred to in clause (a) of sub-section (i) of Section 6.

Section 9 of the Banking Regulation Act, 1949, prohibits a banking company from holding any immovable property, howsoever acquired, except as is required for its own use, for a period exceeding seven years from the acquisition of the property. The Reserve Bank may extend this period by another five years, if it is satisfied that such extensions would be in the interest of the depositors of the banking company. The banking company shall be needed to dispose of such property within the above-mentioned period. Section 6(f) and (g) of the same Act allowed a banking company to manage, sell and realise any property which may come into its possession in satisfaction of any of its claims and to acquire, hold and deal with any property which may form part of the security for any loans or advances or which may be connected with any such security.

Restrictions about Subsidiary Cos. of Banking Cos. :

According to Section 19(/) of the Banking Regulations Act. 1949, a banking company could form a subsidiary company only for the following purposes:

- (i) for undertaking and executing of trusts;
- (ii) for undertaking of the administration of estates as executor, trustee or otherwise;
- (iii) for giving the safe deposit vaults; or

- (iv) for carrying on the business of banking exclusively outside India with the prior permission of the Reserve Bank.

Section 19 was amended in the Banking Laws (Amendment) Act, 1983, and according to the Amended Act, a banking company may form a subsidiary company for one or more of the following purposes:

- (a) for undertaking of any business permitted for a banking company under clauses (a) to (o) of sub-section (i) of Section 6;
- (b) for carrying on the business of banking exclusively outside India (with the previous permission of the Reserve Bank of India);
- (c) for undertaking of such other business which in the opinion of the Reserve Bank would be conducive to the spread of banking in India, or to be otherwise useful or necessary in the public interest.

The business carried on by such subsidiary company shall not be deemed to be the business of the banking company for the purpose of Section 8.

Reserve Bank of India has stipulated that banks can set up subsidiaries to transact equipment leasing business and/or invest in shares of equipment leasing companies within specified limits after obtaining the prior approval of the Reserve Bank of India. Banks are precluded from undertaking directly, *i.e.*, departmentally, the business of equipment leasing.

While a number of banks have been permitted by the Reserve Bank to make portfolio investment in equipment leasing companies, the State Bank of India has entered into this business in a significant way by establishing a subsidiary company, named SBI Capital Markets Ltd., on 1st August, 1986. SBICAP, as it is called, has taken over the business of Merchant Banking Division of the State Bank of India. It gives a range of new services including project advisory services and **equipment** leasing.

Customer :

There is no statutory definition of the term *customer*. There are two schools of thought (old and new) regarding the meaning of this

term. According to the old view, as expressed by Sir John Padget, "To constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business.... It is difficult to reconcile the idea of a single transaction with that of a customer. The world surely predicates, even grammatically, some minimum of custom antithetic to an isolated act. It is believed that tradesmen differentiate between a customer and a casual purchaser." (*Mathews vs. William Brown & Co.*, 1894.)

According to the new school of thought, the relation of banker and customer begins as soon as the cheque is paid in and accepted for collection and not merely when it is paid. (*Lad broke vs. Todd*, 1914.) The word *customer* signifies a relationship in which duration is not of the essence. The contract is not between a habitual and a new customer, but between a person who has an account of his own at the bank. (*Commissioner of Taxation vs. English, Scottish and Austrian Bank*, 1920).

Thus, a person who has an account in a bank in his own name and for whom a banker undertakes to give facilities as a banker, is considered to be a *customer*. It is not essential that the account should have been operated for some time, but it is presumed that the customer will deal regularly with his banker in future.

Another important condition which determines the status of a person as a customer is the nature of his dealings with the banker. The dealings between a banker and a customer must be related to the business of banking.

A customer of a banker need not necessarily be a person. A firm, joint stock company, a society or any separate legal entity may be a customer. Explanation to Section 45-Z of the Banking Regulation Act-1949, classifies that in that section "Customer" includes a Government department and a corporation incorporated by or under any law.

Services rendered to Depositors and Borrowers :

Banks open various types of deposit accounts and give the following services to the depositors and borrowers :

1. Collection of cheques, demand drafts, bills of exchange, promissory notes, hundis and foreign documentary and clean bills.

2. Purchase of local and foreign currency documentary/clean bills, negotiation of bills under inland and foreign letters of credit, advising of inland and foreign letters of credit established by branches and correspondents.
3. Carrying out the standing instructions for the payment of insurance premia, subscriptions, certain taxes and gift remittances.

Ancillary Services :

1. Performance Guarantee and Financial Guarantees.
2. Safe Custody of Deeds, Securities.
3. Safe Deposit Vault.
4. Purchase and Sale of Securities.
5. Collection of Interest on Securities/Debentures and Dividend on Shares, Collection of Pension Bills.
6. Remittance of Funds — Bank Drafts, Mail Transfers, Telegraphic Transfers.
7. Executor and Trustees.
8. Personal Tax Assistance, preparing Income Tax, Sales Tax, Wealth Tax Returns.
9. Investment Facilities — Underwriting, Banker to new issues, Guidance to investment, Stock Exchange assistance.
10. Credit Transfer.
11. Credit Cards.
12. Travellers Cheques and Gift Cheques.
13. Emergency Vouchers.
14. Sale of Units of Unit Trust of India.

(1) **Debtor and Creditor** : The opening of an account with a bank and a banker's acceptance thereof involve a contractual relationship by implication. The depositor is only a creditor, and there is no entrustment to the bank for any particular purpose. The bank is liable to refund the money when demanded, but the money deposited belongs to the bank and the bank is entitled to deal with

it as it likes. Thus, a banker when he deals with his customer is primarily in the position of a debtor to his creditor, or *vice versa*, when the customer has an overdraft.

The basis of the general relationship between a banker and a customer is clearly that of a debtor and a creditor. This was explained in the *Folley vs. Hill*, 1848, as follows:

“Money, when paid into a bank, ceases altogether to be the money of the principal; it is the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into the banker’s is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker’s money; he is known to deal with it as his own; he makes what profit he can which profit he retains to himself, paying back only the principal, according to the custom of bankers in some places, or the principal and a small rate of interest, according to the custom of bankers in other places That being established to be the relative situation of banker and customer, the banker is not an agent or factor but is a debtor.”

A Debt by a Bank vs. an Ordinary Commercial Debt :

There is a difference between the bank-customer relationship and the ordinary commercial debtor-creditor relationship. The debt due from a banker to his customer differs from ordinary commercial debts in one important respect, *viz.*, that the general rule by which a request by the creditor for payments is unnecessary does not apply. In *Joachimson vs. Swiss Banking Corporation*, 1921, it was held that in case of a debt due from a bank, an express demand for repayment by the customer is necessary. In this case, the learned judge said the creation of an indivisible contract as follows:

“The bank undertakes to receive money and to collect bills for its customer’s account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them. The promise to repay is to repay at the branch of the bank where account is kept, and during banking hours. It includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank at

the branch, and as such written orders may be outstanding in the ordinary course of business from two or three days, it is a term of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer on his part undertakes to exercise reasonable care in executing his written orders so as to mislead the bank or to facilitate forgery. I think it is a necessary term of such a contract that the bank is not liable to pay the customer the full amount of his balance until he demands payment from the bank at the branch at which the current account is kept.

Although the relationship between a banker and a customer is mainly that of debtor and creditor, it differs from similar relationship of debtor and creditor of ordinary commercial debts in the following respects:

(a) *The creditor (customer) must demand payment from debtor (banker)*: In a banker-customer relationship, the customer (creditor) must demand payment from the bank (debtor), whereas in the case of an ordinary commercial debt, the debtor must pay the money on the specified date as per the terms of the contract.

(b) *The creditor (customer) must demand payment at the proper place and time* : A proper place means the office or branch of a bank in which the customer has an account. A bank may have many offices or branches, but the customer can demand payment only from the office or branch where he has an account. In *Indo Allied Industries Ltd. vs. National Bank Ltd.* (A.I.R., 1970, Allahabad 108), the Allahabad High Court observed that in the absence of an express contract to the contrary, there was an implied contract with a customer who opened an account with the branch of a banking concern, which carried with it the duty of the bank to pay the customer only at the branch where the account was kept, subject to instructions to transfer the amount elsewhere.

(c) *The creditor (customer) must demand from the debtor (banker) in a proper manner* : The customer can demand payment from the bank only in the manner prescribed by the rules of a bank or in accordance with usage. The statutory definition of a bank itself shows that deposits are with draw able by cheques, drafts, orders or otherwise.

The Law of Limitation (conflict of views between different High Courts removed) : Articles 59 and 60 of the Indian Limitation Act, 1908, define the law of limitation. Article 59 originally provided a period of three years for the recovery of money lent under an agreement and payable on demand from the time when the loan was made. Article 60 originally provided the same period for “money deposited under an agreement.”

Under the Limitation Act, 1963, Articles 59 and 60 of the Indian Limitation Act, 1908, have become Articles 21 and 22 respectively. There was a difference of opinion in the views of the Bombay and Allahabad High Courts. According to the High Courts of Bombay and Allahabad (*Ichha vs. Natha*, 13 B. 388, at p. 342; *Dharamdas vs. Gangadevi*, 29A, 773 at p.778), the legal relationship between an indigenous banker and his customer was that of borrower and lender within the meaning of Section 59, and, therefore, no express demand was necessary for the debt recoverable from an indigenous banker. On the other hand, the High Courts of Calcutta and Madras held that the legal relationship in such cases was that of the deposit and depositor within the meaning of Article 60, and consequently a demand was necessary before the cause of action for a suit to recover a debt from a banker could arise [*laher vs. Jiban*, 16 c.25(28); *Perundeivataya vs. Nam*, 18 M. 390],

The above conflict of views between different High Courts was removed by an amendment of Article 60, in which the words “including money of a customer in the hands of his bankers so payable” have been added after the words “payable on demand.” The effect of the amendment is to make an express demand a necessary condition for a cause of action to recover a debt due from a banker (*Juggi vs. Kishan*, 37A, 292; *Bhima vs. Veni*, 28 Bombay, L.R. 73).

Banker’s Right of Set-off :

The right of set-off is a statutory right which enables a banker to combine two accounts in the name of the same customer and to adjust the debit balance on one account with the credit balance in the other. The following points must be noted in connection with the use of this right by a bank.

A bank may exercise the right of set-off not only in the case of two accounts of a customer in the same branch of the bank but also in the case of two or more accounts of the same customer in different branches of the same bank. The right of set-off may be exercised subject to the fulfilment of the following conditions:

- (a) Both the accounts of the customer must be in the same name and in the same right. The same right means that the capacity of the account holder in both or all the accounts must be the same. The underlying principle in the rule of “the same right” is that funds belonging to someone else but standing in the name of the account holders should not be made available to satisfy his personal debts.
- (b) For example, the funds in a Trust Account are deemed to be in different rights, and, therefore, a debit balance in a personal account cannot be set-off against the credit balance in the Trust Account which may be in the name of the customer.
- (c) The right of set-off may be exercised by a bank only in respect of debts due to and not in respect of future debts or contingent debts.
- (d) The right of set-off may be exercised by a bank only if there is no agreement to the contrary.

A Customer has no Right of Set-off or an Appropriation :

Although a banker has the right of set-off between two or more accounts of a customer before making any payment to him, a customer has no such right of getting his two or more accounts considered before the banker pays his cheque. In *Mohammed Hussain vs. Chartered Bank*, 1965, the appellant had an account in a Madras branch of the Chartered Bank and another in its Karachi branch. The banker agreed to provide Rs. 3.50 lakhs overdrafts to the appellant, which was later reduced to Rs. 2.50 lakhs. The appellant wrote one cheque on the Madras branch which was returned with the remark: “Cheque is far more than overdraft amount.” The customer claimed that he had enough funds in the account of the Karachi branch and if that were taken into account, the cheque

would never have been dishonoured. The Court held that the banker had the right to set-off between different accounts of a customer, but that the customer had no such right.

Banker's Right of Appropriation :

In normal course of business, a banker receives payments from customers. In case a customer has taken more than one loan or has more than one loans or has more than one account with the bank, the question of appropriating the amount deposited by the customer arises. The customer has, naturally, the right to direct the bank to appropriate the amount to any of the accounts of the customer. In the absence of any such direction from the customer, the banker shall have the right to appropriate the payment to any debt or account according to his discretion. But the banker should inform the customer accordingly.

Banker's Right to Charge Interest and Other Charges etc. :

A banker has the implied right to charge interest on loans given to the customers, because when a banker grants a loan to a customer, he becomes a creditor and the customer a debtor. The normal practice followed by the bankers is to debit the customer's account periodically with the amount of interest due from the customer. In some cases, the agreement between the banker and the customer may, on the other hand, stipulate that interest may be charged at compound rate also. In *Konakalla Venkata Satyanarayana & Others vs. State Bank of India* (AIR 1975, AP, 113) the agreement provided that "interest. . . shall be calculated on the daily balance of such account and shall be charged to such account on the last working day of each month." The customer availed the overdraft facilities for many years and periodical statements of accounts were being sent to the customer showing that interest was being charged and debited at compound rate and no objection was raised at any time. It was held by the High Court in this case that there was no doubt that the customer had agreed to the compound rate of interest being charged and debited to his account. The customer need not pay the amount of interest in cash. The interest amount is debited in the account of the customer and it is deemed as the debt due from the customer to the banker and interest accrues on this amount also along with the

debt. Similar practice is followed in allowing interest on savings bank accounts.

Trustee : In the case of securities and valuables deposited with a bank for safe custody, the position of the banker is that of a trustee, and he is liable to return them to the customer when demanded. For example, when a customer pays into his bank a cheque drawn upon another bank, such a cheque is received by the bank as a bill for collection (BC); the customer, therefore, is entitled to claim the cheque, if the collecting bank fails before the bank has collected it and the proceeds of the cheque, if it has credited the amount to his account. If, on the other hand, the deposit has been made for a specific purpose, the banker stops the payment before applying it to such purpose, and the depositor cannot claim the money paid and must content himself with his right of proof as a general creditor. [*In re: Barning's Banking Co. (1871) 40 L.J. Ch. 730*].

Normally, a banker requires articles for safe custody to be delivered in a sealed packet or box, and he has to return it with all the seals intact to the deposit or to one who has his order for the purpose. It has been held in several cases that wrong delivery of articles, kept with the banker for safe custody, to an unauthorised person is nothing less than a conversion, *i.e.*, putting the goods bailed to one's own use, and is, as such, punishable under the law.

Case where the Banker is a Trustee :

There are many cases where a banker places himself in the position of a trustee. In the case, the *Official Assignee of Madras vs. J.W. Iron*, 8 M.L.T. 99, a remittance was sent to a banker with instructions to purchase shares in a certain company. The bank brought some shares, but before completing the rest of the purchase, it failed. It was held that the bank stood in the position of a trustee to the remitter and therefore, he was entitled a refund of the unspent balance of the amount.

In another case, a banker received money from one party on behalf of another (the latter not being a customer) and wrote to the latter inquiring what was to be done with it, intimating at the same time that the amount was held in suspense. It was held that the relationship of debtor and creditor not being established, the latter

can recover the amount in full out of the bank's assets in the event of its failure. (*Official Assignee of Madras vs. D. Rajaram Aiyar*, 33 Mad., 299).

In a case where a person had a deposit account with a banker and asked the banker to buy certain securities out of the money which the banker agreed to do, but the bank failed before he did so, it was held that this agreement did not make the bank a trustee for the amount in deposit (*Official Assignee of Madras vs. The Society for Providing Christian Knowledge*, 8 M.L.T. 52).

Where a banker, pursuant to instructions, express or implied, has credited the proceeds of a bill or other document entrusted to him for collection, the relationship of debtor and creditor arises from the time of his doing so. Where, however, the banker has suspended his business before receipt of such amount, he holds the money as a trustee for the customer, irrespective of whether or not the latter had an account with him on the date of the receipt of the money and whether or not the money had been credited in that account.

(*Jinj Sports Ltd. vs. New Bank of India Ltd.*, 1948 Comp. Cas. 253).

Agent : In the course of business incidental to banking, a banker undertakes to perform many services for the customer such as —

- (i) buying and selling securities on his behalf;
- (ii) collection of cheques, dividends, bills or promissory notes on his behalf;
- (iii) acting as a trustee, attorney, executor, correspondent or a representative of a customer.

In the performance of all above functions, the banker acts as an agent of the customer.

Adviser : Bankers also advise customers on their investments in the shares and debentures of joint stock companies and other securities. In performing this function, they act as advisers to customers. When some advice is given by a bank officially, it must be given with the ordinary care and skill that a bank official is expected to exercise and possess, even when such advice is given to a person who is not a customer at that time. In one case, a bank had advertised that expert advice was one of the advantages it offered to

customers. The advice was honestly given, but there was no reasonable ground for advising the plaintiff in his own interest to make certain investments. The bank was held liable (as also the manager himself) for the loss occasioned by the advice.

[*Woods vs. Martins Bank Ltd. & Anr.* (958) 3 All. E. R. 166].

Special Relationship :

(1) ***Banker's Obligation to Honour Cheques*** : A banker is under statutory obligation to honour the cheque drawn by a customer so long as his balance is sufficient, provided that the cheques are presented within a reasonable time after the ostensible dates of their issue, and provided that no prohibitory order of a Court is standing against the account of the customer. This duty is imposed upon the banker by Section 31 of the Negotiable Instruments Act, 1881, which reads as follows:

“The drawee of a cheque, having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheques, must pay the cheque when duly required so to do and in default of such payment must compensate the drawer for any loss or damage caused by such default.”

The obligation to honour a customer's cheques may be extended by an agreement, expressed or implied, to the amount of overdraft agreed upon; otherwise the banker is not liable for dishonouring his customer's cheques for the meeting of which the latter has not sufficient funds with the former.

Reasonable Time :

It is the duty of a customer to ensure that a cheque is complete in all respects, and is presented within a reasonable time. According to custom and practice in our country, a reasonable time for the presentation of a cheque is six months after the date of issue.

Collection of Cheques :

When a customer gives a cheque to a banker for collection, what should be the reasonable time for crediting funds before they can be drawn upon? A banker is not bound to credit his customer's account with the amount of cheques or drafts upon other banks,

sent in for collection, before they are realised. The amount must, however, be credited to the customer's account within a reasonable time after realisation. The question what constitutes a reasonable time depends upon the circumstances in each case.

Garnishee Order :

The banker's obligation to honour a customer's cheques is extinguished on receipt of a Court order known as the *Garnishee Order*, which is issued under Order 21, Rule 46 of the Code of Civil Procedure, 1908. A Garnishee Order is an order of a Court to a bank prohibiting it from making any payment from the customer's account. It is issued in two parts. In the first part, the Court directs the banker to stop payment from the account of the customer (judgement-debtor). This order, which is called *Order Nisi*, also seeks an explanation from the banker as to why the funds in the said account should not be utilized to meet the judgement-creditor's claim. On receiving the *Order Nisi*, the banker should immediately inform the customer so that the latter may not issue any cheques which may be dishonored. The second part of the order, which is called *Order Absolute*, is the final order by which the entire balance in the account or a specific amount is attached and is to be handed over to the judgement-creditor. After receiving such an order, the banker is bound to pay the ordered amount to the judgement-creditor, and his liability towards the customer is discharged to that extent.

Application of Garnishee Order on Joint Account :

An account which is opened in the name of two or more persons is called a joint account. This account cannot be attached under the Garnishee Order if only one of the account holders is a judgement-debtor. But if both or all the account holders are judgement-debtors in any legal proceedings, the joint account can be attached.

Partnership Account :

For the debts incurred by a partnership firm, the personal accounts of all the partners can also be attached in addition to the account of the firm, because the liability of the partners is both joint and several. When a partner is a judgement-debtor in his individual

capacity, only his individual account may be attached and not that of the firm or of another partner.

Trust Account :

A trust account, though standing in the name of a person in his capacity as a trustee, cannot be utilized for the payment of his personal liabilities.

Attachment of Bank Account According Income Tax Act :

Section 226(3) of the Income Tax Act, 1961, authorizes an Income-tax Officer to attach the credit balance in the account of a customer if he makes a default in the payment of the tax due from him. This section authorizes an Income-tax Officer "to require by notice in writing any person from whom money is due or may become due to the assess, or any person who holds or may subsequently hold money for or on account of the assess, to pay to the Income-tax Officer an amount equal to the amount of the arrears of tax or the whole amount, if it is equal to or less than the amount of such arrears."

Wrongful Dishonour :

If a banker, without justification, dishonours his customer's cheque, he makes himself liable to compensate the customer for injury to his credit (*Marzetti vs. Williams*, 1830). According to Section 31 of the Negotiable Instruments Act, 1881, the words "loss or damage" do not mean only pecuniary loss, but also loss of credit or injury to reputation. The loss can be of following two types:

- (i) Nominal loss;
- (ii) Special or substantial loss.

If a customer is a trader or a businessman, the damages may be substantial; but a non-trader is not entitled to recover substantial damages for the wrongful dishonor of his cheque unless the damage he has suffered is alleged and proved as special damage.

The amount of damages will not necessarily be large only because the amount of the cheque dishonored is large, for a customer is supposed to suffer more in credit if his cheque for a small amount is dishonored than if it is one for a large amount. (*Davidson vs. Barclay's Bank Ltd.*, 1940).

Traders and businessmen are entitled to claim from the bank not only general damages, but substantial damages for such loss of credit or reputation even without proving the special loss or damage suffered by them because, in their case, loss or damage is presumed. But if a special loss or damage can be proved, this fact, too, would be taken into consideration for arriving at the exact amount of damages. In *New Central Hall vs. United Commercial Bank Ltd.* (A.I.R. 1959) Madras 159, the Madras High Court held: "In case where a cheque issued by a trader-customer is wrongly dishonored, even a special damage could be awarded without proof of special loss or damage. The fact that such dishonours took place due to a mistake of the bank is no excuse, nor can the offer of the bank to write and apologize to the payees of such dishonored cheques affect the liability of the bank to pay damages for their wrongful act."

The liability of a bank for a wrongful dishonours of a cheque is towards the drawer and not the payee of the cheque. The payee or the holder of the cheque cannot make the banker liable for such dishonours. (*Meghiya Malsa Ltd. vs. P.S. Common*, A.I.R. 1963, Kerala 306).

In the case of a wrongful dishonours of a non-trader customer's cheques, the loss of credit or reputation is not to be taken into account. Hence he is entitled to nominal damages.

Banker's Lien : Another important feature of the relationship between a banker and a customer is that a banker may, in the absence of an agreement to the contrary, retain as a security for a general balance of the account any goods and securities bailed to him (Indian Contract Act, 1872, Sec. 171).

A lien is the right of a person in possession of goods to retain them until the debts due to him have been paid.

General Lien :

This is a right to retain goods not only for the debt incurred in connection with them but also for the general balance owing by the owner of the goods to the person exercising the right of lien.

Particular Lien :

This is a right to retain the goods in respect of which the debt arises.

A banker has a general lien on all securities deposited with him by a customer unless there is an express contract, or unless there are circumstances showing an implied contract inconsistent with the lien. (*Brando vs. Barnett*, 1864). This general lien of the banker is an implied pledge, and may be exercised by him on bills, notes, cheques, bonds, coupons and dividend warrants. The right of sale extends to all the properties and securities belonging to a customer in the hands of the banker, except the title deeds of immovable property which cannot be sold. But a banker has a right to retain even the title deeds.

A banker cannot exercise the right of lien on safe custody deposits, on deposits for a special purpose, on valuables left with the bank by mistake, on valuables left to cover an advance which was not granted, on securities handed over to the bank for sale; nor on trust money with the customer.

No Specific Agreement Necessary :

According to Section 171 of the Indian Contract Act, 1872, an agreement for the creation of a lien is implied, and, therefore, no specific agreement is necessary to create the right of lien. In order that the lien should arise, (a) the property must come into the hands of the banker in his capacity as a banker; (b) there should be no entrustment for a special purpose inconsistent with the lien; (c) the possession of the property must be lawfully obtained in his capacity as a banker; and (d) there should be no agreement inconsistent with the lien.

The law of limitation does not bar a banker's right of lien. The effect of the limitation law is only to bar the remedy and not to discharge the debt. Therefore, it does not affect property over which the banker has a lien. The banker has no right of lien on a trust account which is separately maintained by a customer. (*Expert Kingston L.R. 6 Ch. 632: ORM vs. Nagappa Chettiar*, 43 Boni L.R. 440, P.C.) A lien can be exercised if a banker has no knowledge, and during the currency of the account has received no notice of the trust character of the funds. (*Union Bank of Australia Ltd. vs. Murra Ayusley* 1898 A.C. 693).

General vs. Particular Lien :

There is a principle that a particular lien defeats a general lien, and, therefore, where a banker has a particular lien, he cannot also claim a general lien. For example, supposing that securities worth Rs. 2,00,000 were deposited with a banker to secure a debt of Rs. 1,50,000. Here, the banker gets a particular lien to the extent of Rs. 1,50,000 plus interest. In case the customer fails to pay this amount, the banker can recover it out of these securities of Rs. 2,00,000; but he cannot claim a general lien on the balance of Rs. 50,000 for some other debt which the customer owes him. The customer is entitled to have the securities, deposited by him for specific advances, returned to him on payment of those advances. (*Wilkinson and Others vs. London & County Banking Co.* 1984, I.T.L.R. 637). If, however, the securities are allowed to remain with the banker after the specific loan is paid up, the banker will acquire a general lien. (*In re: London & Globe Finance Corporation*, 1902, 2 Ch. 416 at p.424). But if a specific pledge cannot be proved under Section 171 of the Indian Contract Act, 1872, a general lien will apply. (*Kunhan Mayan vs. Bank of Madras*, 19 Mad. 234).

(3) **Secrecy of Accounts** : A banker should take care not to disclose the condition of his customer's account except on reasonable and proper occasions. This obligation to observe secrecy of account does not end even with the closing of a customer's account. (*Tousier Case 1924*). It is an implied contract between a banker and his customer that the former will not divulge to a third person the state of the latter's account without his express or implied consent.

Reasonable and proper occasions for disclosure may be as follows :

(i) **Under Compulsion of Law**: For example, under orders of the Government, a Court or of Income Tax authorities, etc.

(ii) **Under the Income Tax Act, 1961**: Vide Sections 131 and 133, Income Tax authorities have powers to call for the attendance of any person or for necessary information from a banker for the purpose of assessment of the bank's customers.

(iii) **Under the Companies Act, 1956**: When the Central Government appoints an Inspector to investigate the affairs of any

joint-stock company under Section 135 or Section 137, the banker must produce all books and papers relating to the company.

(iv) *Court's Order under the Banker's Books Evidence Act, 1891*: A Court may also order a banker to disclose information relating to a customer's accounts. The Banker's Books Evidence Act, 1891, provides that certified copies of entries in the banker's books are to be treated as sufficient evidence, and the production of the books in the Court cannot be forced upon him. This protects a banker against the inconvenience of attending in a Court and producing his account books as evidence. According to Section 9 of the Act, "a certified copy of any entry in a banker's book shall in all legal proceedings be received as *prim a facie* evidence of the existence of such entry and shall be admitted as evidence of the matter, transaction and accounts therein recorded in every case where, and to the same extent as, the original entry itself is now by law assembled, but not further or otherwise."

(v) *Under the Reserve Bank of India Act, 1934*: The Reserve Bank of India collects credit information from banking companies and also furnishes consolidated credit information to any banking company. Every banking company is under a statutory obligation under Section 45B of the Reserve Bank of India Act, 1934, to furnish such credit information to the Reserve Bank.

(vi) *Under the Banking Regulation Act, 1949*: According to Section 26 of the Banking Regulation Act, 1949, every banking company is required to submit an annual return of all such accounts in India which have not been operated upon for 10 years. Banks are required to give particulars of the deposits to the credit of each account.

(vii) *Disclosure to Police*: Under Section (3) of the Criminal Procedure Code, a banker is not exempted from producing his account books before the police. The police officers conducting an investigation may also inspect a banker's books for the purpose of such investigations. (Section 5, Banker's Books Evidence Act, 1891).

(ix) *Under the Foreign Exchange Regulation Act, 1933*: Banking companies dealing in foreign exchange business are designated as authorized dealers in foreign exchange. Section 43 of the above Act empowers the officers of the Directorate of Enforcement and the

Reserve Bank to inspect the books and accounts and other documents of any authorized dealer and also to examine on oath such dealer or director of a bank or an official in relation to its business.

Reasonable and proper occasions for disclosure may be as follows :

(i) Under compulsion of law, *e.g.*, under orders of the Government, Court or Income Tax authorities, *etc.*

(ii) *Information to the Proposed Guarantor*: A guarantor has a right to be informed of the extent of his liability and the banker is justified in disclosing to him information about a customer's account so far as it is necessary for the purpose.

(iii) A banker is under a public duty to disclose information in case of danger of treason to the State.

(iv) Where a customer gives the name of his banker for reference, the latter will be justified in answering trade references.

(v) When a banker's own interests are in jeopardy, he can disclose the state of a customer's account.

Risks of Unwarranted and Unjustifiable Disclosure : The obligation of the banker to keep secrecy of his customer's accounts — except in circumstances discussed above — continue even after the account is closed. If a banker discloses information unjustifiably, he shall be liable to his customer and the third party as follows :

(a) *Liability to the customer*". The customer may sue the banker for the damages suffered by him as a result of such disclosure. Substantial amount may be claimed if the customer has suffered material damages. Such damages may be suffered as a result of unjustifiable disclosure of any information or extremely unfavourable opinion about the customer being expressed by the banker.

(b) *Liability to third parties* : The banker is responsible to the third parties also to whom such information is given, if :

(i) The banker furnishes such information with the *knowledge that it is false*, and

(ii) Such party relies on the information and suffers losses.

Such third party may require the banker to compensate him for the losses suffered by him for relying on such information. But the banker shall be liable only if it is proved that he furnished the wrong or exaggerated information deliberately and intentionally. Thus he will be liable to the third party on the charge of fraud but not for innocent misrepresentation. Mere negligence on his part will not make him liable to a third party.

This point was very clearly decided by the House of Lords in *Hedley Byrne and Co. v. Heller and Partners Ltd.* (1964). In this case the banker of a company, in reply to an inquiry from a firm of advertising agents, gave his opinion as follows: "The company was a respectably constituted company, considered good for its ordinary business engagements." The banker also added that the figure of 100,000 (mentioned by the enquire) was larger than they were accustomed to see. The banker also stated that the opinion was given without responsibility on the part of the answering bank or its officials. The company subsequently went into liquidation and the advertising firm suffered a loss of 17,000 and sued the company's banker for the recovery of this amount on the ground that the replies were given negligently and in breach of duty to exercise care in giving them.

The Trial Court held that though the banker was negligent in his assessment of the position of the company but dismissed the claim on the ground that the banker owed no duty of care to the advertising firm. The House of Lords upheld this decision. Lord Reid stated that in general an innocent and negligent misrepresentation given by itself no cause of action and that there must be something more than mere misstatement in order to fasten liability on the person making it. Lord Morris observed that the banker, of whom the reference was made, was not expected to make a detailed inquiry and produce a well-balanced report. All that was expected was that he should answer honestly the question put to him from what he knew from the books and accounts before him.

The general conclusions of the Court can be summarized as follows:

- (i) A banker answering a reference from another banker on behalf of the latter's constitution owes a duty of honesty to the said constituent.

- (ii) If a banker gives a reference in the form of a brief expression of opinion in regard to creditworthiness, he does not accept and there is not expected of him any higher duty than that of giving an honest answer.
- (iii) If the banker stipulates in his reply that it is without responsibility, he cannot be held liable for negligence in respect of the reference.

Banker's Right to Claim Incidental Charges : As long as the banker-customer relationship exists, a banker has an implied right to charge a commission, interest and other charges for the different services rendered by him to a customer. Subject to an agreement to the contrary, a banker has the right to charge six-monthly compound interest on overdrawn amounts.

Law of Limitation on Bank Deposits : Under the Law of Limitation, a creditor forgoes the right to recover the amount due from a debtor after the expiry of the period of limitation. In the case of bank deposits, however, the period of limitation does not begin till a demand for payment is made by the customer, and not from the time of receipt of deposits. (*Joachimson vs. The Swiss Bank Corporation*, 1921).

According to the provisions of Section 26 of the Banking Regulation Act, 1949, banking companies have to submit an annual return of all accounts which have not been operated for ten years, giving particulars of the deposits standing to the credit of each such account; but in the case of money deposited for a fixed period, the period often years will be counted from the date of expiry of such fixed period.

Entries in the Pass Book : Another important feature of banker-customer relationship is whether entries in the pass book are finally binding on the customer. According to Sir John Paget: "The proper function which the pass book ought to fulfil is to constitute a conclusive and unquestionable record of transactions between the banker and the customer, and it should be recognised as such. After full opportunity of examination on the part of the customer, all entries, at least to his debit, ought to be final, and not liable to be subsequently reopened, at any rate to the detriment of the banker."

The legal position in connection with entries in the passbook is not satisfactory because of some conflict in Court decisions. But it is generally accepted that entries in the pass book are not finally binding on the customer. It was laid down in *Dank of England vs. Valiano 1891* as follows:

“The mere fact that a customer of a bank takes his pass book out from the bank and returns it without objection to any of the entries contained therein, being a pencil entry of the balance, does not amount to a settlement of account in between him and the banker in respect of these entries.”

Wrong Entries :

Wrong entries in the pass book are of following two types:

- (i) Entries in favour of the customer; and
- (ii) Entries in favour of the bank.

(i) *Wrong Entries in Favour of Customer*: In the case of that class of customers who spend all their income and do not keep a balance in the account, if a banker, by an error, credits such a customer with an amount and the customer, relying on the accuracy of the pass book draws cheques, and thus alters the position, the banker cannot subsequently debit him and recover this amount. (*Skyring vs. Greenwood. 1925. Holf vs. Markham, 1923*).

(ii) *Wrong Entries in Favour of Bank* : Where a banker, on the other hand, makes an erroneous entry in favour of himself which will have to be rectified unless he proves that the account was settled as between himself and his customer, in what circumstances would the account be considered as settled? The only course open to the banker is to get in writing from the customer that an erroneous entry was made in the pass book. This is generally done by bankers periodically sending letters to customers stating the balance at the close of a particular period, to which are attached blank forms of acknowledgement as to the correctness of the amount which they are requested to fill in, sign and return. But the customer cannot be compelled to sign such a statement.



CHAPTER



REQUISITES OF A CHEQUE

According to Section 6 of the Indian Negotiable Instruments Act, 1881:

“A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand.” According to Section 5 of the Act:

“A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker directing a certain person to pay a certain sum of rupee only, to or to the order of, a certain person or to the bearer of the instrument.” From the above definition it follows that an instrument to be called a cheque must fulfil some conditions. These are:

1. The instrument must be in writing. Legally speaking the writing may be done by means of printed characters, type-writer, or by a pen or pencil. But bankers do not generally honour cheques drawn in pencil, unless confirmed by the drawer. This is because, it is easy to make unauthorised alterations when a cheque is drawn in pencil.
2. The instrument must contain an unconditional order. For instance, if the banker is ordered to pay a certain sum provided the payee fulfils certain conditions, if cannot be

considered a cheque as the order is a conditional one. However, if such instruments are addressed to the payee and not to the banker, the order to pay may be regarded unconditional.

3. The maker must sign the instrument. In order to be a valid cheque, the instrument must contain the signature of the drawer. In the case of an illiterate person, his thumb impression will suffice. Though legally permissible, pencil signatures are discouraged by banker. So also signatures impressed on the cheque by means of a rubber stamp is not permitted generally.
4. The order to pay must be addressed to a banker, and that banker must be a specified one. In other words, the instruments should not only be drawn on a banker, but on a specified banker.
5. The order must be for a certain sum of money only. The term 'money' means legal tender currency. Thus, if the order is for something other than legal tender currency, the instrument cannot be considered a cheque. Further, the sum of money must be certain. Here it may be pointed out that the amount should be considered as a certain amount even when the cheque is drawn in any foreign currency. So also, the amount is certain when it is payable with interest at a given rate up to the date of happening of a fixed future event.
6. The instrument must be payable to or to the order of a certain person or to the bearer. It follows that if a cheque is not payable to bearer, the payee must be named or otherwise indicated therein with reasonable certainty. He may be designated as the holder of an office. Further, the payee need not be a human being, it can be a legal person also.
7. Amount must be payable on demand.

Difference between A Cheque and A Bill of Exchange :

1. A bill of exchange may be drawn on any person, and the person need not be necessarily a banker. On the other hand, a cheque is a bill of exchange drawn on a specified banker.

2. A Bill of exchange may be, made payable on the expiry of a certain period after date. But a cheque is not expressed to be payable otherwise than on demand.
3. Acceptance is necessary in the case of a bill of exchange. But it is not so in the case of a cheque.
4. Days of grace are allowed in the case of time bills. But in the case of a cheque days of grace are not allowed.
5. Cheques may be crossed, while a bill of exchange cannot be crossed.
6. The payment of a cheque should be suspended on the receipt of notice of the death or insolvency of the drawer. This is not the case with a bill of exchange.

Dating of Cheques :

A cheque is not invalid merely on the ground that it is antedated or postdated, or that it bears date on a Sunday. A cheque not dated at all is also valid. Any holder of the instrument, including a banker, may insert a date. Nevertheless, bankers generally return undated cheques. According to the decision in *Dalton V Griffiths*, a banker is not bound to honour undated cheques.

An antedated cheque is one that bears a date earlier than the date of issue. A banker cannot refuse payment of a cheque on the ground that it is antedated.

A post-dated cheque is one that bears a date later than the date of issue. A post-dated cheque is a negotiable instrument. Following example may make this point clear. A gives B a post-dated cheque, and B before the due date, gives it to C in payment of a debt. C takes the cheque in good faith. A stops payment because of B's failure to fulfil his contract. However, C acquires a good title to the cheque, and when the due date arrives he can sue A for the amount.

Crossing of Cheques :

The Negotiable Instruments Act 1881 of India, recognizes crossings of cheques. A crossing is a direction to the paying banker that the cheques should be paid only to a banker and if the banker is named in the crossing, only to that banker.

This ensures the safety of payment by means of cheques. The holder of the cheque is not allowed to cash it across the counter.

There are two kinds of crossing, namely general crossing and special crossing.

General Crossing : Section 123 of the Negotiable Instruments Act 1881, defines a general crossing as follows:

“Where a cheque bears across its face an addition of the words ‘& company’ or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply either with or without the words ‘not negotiable’ that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally”. Following are given specimens of general crossings.

1	2	3	4	5	6
	and company	& Co	Not Negotiable	Account payee	Account Payee's

Thus, two parallel transverse lines are the essential part of a general crossing. The words ‘account payee’ ‘payees account’, ‘not negotiable *etc.*’, do not, in the absence of two parallel transverse lines, constitute general crossing.

Where a cheque is crossed generally, the paying banker should not make payment except through a banker. The addition of the words “account payee” or “payee’s account” to the crossing increases the safety of the cheque. Such words, however, cannot be strictly considered addition to the crossing. The paying banker’s position remains practically the same. In fact they are intended to warn the collection banker that the amount should not be collected except for the benefit of the payee’s account.

The words “not negotiable” also do not place any responsibility on the paying banker. The words merely act as a warning that the transferee of a cheque so marked shall not be capable of acquiring a better title to it than was possessed by his immediate transferor, and no duty is imposed on the paying banker to enquire into the title to the holder. A “not negotiable” crossing does not make the cheque non-transferable. But the transferee does not get a better title than that of the transferor (Great Western Railway Company V London and County Banking Co.).

Special Crossing : Section 124 of the Negotiable Instruments Act 1881 of India, defines a special crossing as follows:

Where a cheque bears across the face an addition of the name of a banker with or without the words “not negotiable”, that addition shall be deemed to be crossing and the cheque shall be deemed to be crossed specially and to be crossed to that banker.

Following are some specimens of special crossing:

1	2	3	4	5	6
The Bank of India	The Bank of India	Not Negotiable The Bank of India	The Bank of India A/c Ramnaran	The Bank of India Account payee	The Bank of India Account Payee

A special crossing warns a paying banker that the amount should be paid only to the banker whose names is given in the crossing. It is not necessary that there should be two parallel transverse lines in the case of a special crossing. The name of a banker is sufficient to constitute a special crossing. A specially crossed cheque may be made more secure by the addition of such words as account payee, not negotiable etc,

Persons Authorized to Cross A Cheque :

Section 125 of the Negotiable Instruments Act 1881, which corresponds with Section 77 of the Bill of Exchange, Act 1882 enacts:

“A cheque may be crossed generally or specially by the drawer”.

“Where a cheque is uncrossed, the holder may cross it generally or specially”

“Where a cheque is crossed generally, the holder may cross it specially”

“Where a cheque is crossed generally or specially, the holder may add the words not negotiable”

“Where a cheque is crossed specially, the banker to whom it is crossed may again cross it especially to another banker, his agent, for collection”

“Where an uncrossed cheque, or a cheque crossed generally, is sent to the banker for collection, he may cross it specially to himself.”

It should be, however, noted that in the last case, such crossing does not enable the collecting banker to avail himself of the statutory protection against being sued for conversion.

Who can Open Crossed Cheques :

The drawer alone has the right to open a crossed cheque by writing the words "please pay cash", and adding his signature to it. It should be remembered here that this method of opening a crossing does not have any legal authority behind it. It is dependent upon the custom of bankers. As observed by Sheldon, if the drawer's opening and signature or initials were forged, and the forger succeeded in cashing the cheque, the banker would undoubtedly be unable to debit his customer, and would also be liable to the true owner.

Endorsements

An endorsement is the signature of the drawer or holder of a negotiable instrument for the purpose of negotiation. In terms of Section 15 of the Negotiable Instruments Act, 1881, of India when the maker or holder of a negotiable instrument signs the same otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he said to endorse the same, and is called the endorser. Thus, an endorsement may be made either on the face or back of the instrument or on a slip of paper annexed thereto, although it is generally made on the back of the instrument. The slip of paper annexed to the instrument for the purpose of making endorsement is known as an "along".

Significance of Endorsements :

When a cheque is endorsed and delivered, the endorsee or transferee gets a valid title to it. He, in term, can negotiate the cheque to anyone he likes, provided his endorser did not restrict further endorsements.

The transferor, by his act of endorsing the cheque, warrants to his immediate transferee and to any subsequent holder, that when

the cheque left his hands he had a good title to it, that it was a genuine one in every particular at the time of his endorsement, and that any endorsements, on it previous to his own were genuine endorsements. Thus, if the cheque is dishonored, the holder can sue any of the previous parties, and recover the amount of the cheque from all previous parties.

When, however, a cheque is endorsed back to an earlier endorser, none of the intermediate parties are liable to him. The object is to prevent a circuitry of action. This is technically known as negotiation back. Let us take following example: A endorses a cheque to B, B to C, C to D, D to E and E to A. Now A is the holder of the cheque. He can sue E, D, C or B. Nevertheless, he himself is liable to B, C, D and E as the original endorser. Hence, if A is allowed to sue, E, D, C, or B, and they in turn, can sue A. In order to prevent this circuitry of action, he is not allowed to sue the intermediate parties.

A can further negotiate the bill if he cancels the endorsements of the intermediate parties, namely B, C, D and E. This is technically known as taking up of a Bill.

Kinds of Endorsements :

There are different kinds of endorsements, namely endorsements in blank, endorsements in full, restrictive endorsements, partial endorsements and conditional endorsements.

In the case of an endorsements, in blank, which is otherwise known as a general endorsement, it specifies no endorsee. The endorser merely puts his signature. The cheque then becomes payable to bearer. When the endorsement specifies the person to whom, or to whose order, the cheque is payable, it becomes a full endorsement (special endorsement). For instance, if a cheque is payable to A or order and he simply puts his signature on the back of the instrument, the endorsement is an endorsement in blank, and the cheque becomes payable to bearer, A specifies the name of the endorsee as B above his signature, then the endorsement is an endorsement in full.

Any holder of a cheque with an endorsement in blank make convert the endorsement into an endorsement in full. Under section

49 of the Negotiable Instrument Act 1981 of India, a holder of a cheque endorsed in blank may convert the endorsement in blank into an endorsement in full, by writing above the endorser's signature a direction to pay the instrument to another person or his order. Here, the transferor, by the endorsement stands to gain in that he transfers the instrument without incurring the liabilities of an endorser.

For instance, a cheque is originally payable to A or order. A endorses the cheque in blank and delivers it to B. The cheque is payable to bearer. However, if B adds the words pay to C or order above the signature of A, the endorsement become an endorsement in full. The cheque is payable to C or his order. It is important to note here that B is not liable as this endorsement acts as an endorsement in full from A to C. An endorsement is restrictive which prohibits further negotiation of the instrument or which expresses that it is a mere authority to deal with the instrument as thereby directed and not a transfer of the ownership there of, as for example, if an instrument be endorsed "Pay X only or Pay X for the account of A" or "Pay X or order for collection" or "the within must be credited to X" or "Pay X for my use."

A restrictive endorsement gives the endorsee the right to receive payment of the cheque and to sue any party thereto that his endorser could have sued, but gives him no power to transfer his rights as endorsee unless it expressly authorizes him to do so. Where a restrictive endorsement authorizes further transfer, all subsequent endorseees take the bill with the same rights and subject to the same liabilities as the first endorsee under the restrictive endorsement.

A partial endorsement is one, which purports to transfer to the endorsee a part only of the amount payable. In terms of Section 56 of the Negotiable Instruments Act, which corresponds with Section 32 of the Bills of Exchange Act, a partial endorsement does not operate as a negotiation of the bill.

A conditional endorsement excluded the liability of the endorser. Thus, if an endorser wants to get rid of his liability in the event of the cheque being dishonored, he can do so by writing the words sans reoccurs, or without recourse to me, after his endorsement. Here the endorser excludes his liability.

Thus, if A endorses a cheque with the addition of the words 'with out recourse to me, subsequent endorsees cannot look at A in case of dishonour of the instrument. At the same time, in terms of clause 2 of Section 22 of the Negotiable Instrument Act, where such an instrument is negotiated back to A after a certain period, all intermediate endorsers are liable to him. For instance, A endorses a cheque with the words without recourse to me to B. B endorses it to C, C to D and D to E. Here A is not liable to B, C, D or E. If however, the cheque is negotiated back to A, B, C, D and E are liable to him.

Again a conditional endorsement may make the liability of the endorser dependent on the happening of a contingent event or may make the right of the endorsee to receive payment in respect of the instrument dependent on the happening of such an event. Such conditions may be either conditions precedent or conditions subsequent. In the case of a condition precedent, the right to recover the amount does not pass on to the endorsee until the condition is fulfilled. For instance, where a cheque is endorsed with a condition "pay on his marrying X", it is a condition precedent, and A gets title only if he marries X. In the case of a condition subsequent, the right of the endorsee is defeated on the fulfilment of the condition. For instance, where a cheque is endorsed with a conditions "pay A or order unless before payment, it is countermanded", it is a condition subsequent, and the endorsee does not get a title if, before payment, the condition is fulfilled.

Where an endorser extends his own liability by stipulating in the endorsement that he waives presentment or notice of dishonour, it is known as a facultative endorsement where an endorser does not want the endorsee or any other holder to incur any expense on his account on the instrument the endorsement is sans fraise.

In this connection an important difference between conditional and restrictive endorsement may be noted. In the former case, it does not affect the negotiability of instrument, in the latter case it restricts the negotiability of the instrument.

Holder and Holder in Due Course

According Section 8 of the Negotiable Instrument Act 1881 of India, a holder of a negotiable instrument is defined as follows:

“The holder of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties there to”. Thus, a holder is a person who is legally entitled to recover the amount from the parties of the instrument and who is in possession of the instrument. Here, the Indian Law makes a slight departure from the English Law. Under the Bills of Exchange Act, a holder means the payee or endorsee of a bill or note, who is in possession of it, or the bearer thereof. In terms of this definition, the holder need not necessarily be a lawful holder. For instance, the finder of a cheque duly endorsed so as to make it payable to bearer is a holder. But according to the Negotiable Instruments Act, the holder must be entitled to receive or recover the amount due thereon from the parties thereto. Therefore, a person who has obtained possession of an instrument by theft or by any other unlawful methods is not a holder.

Section 9 of the Negotiable Instruments Act 1881 of India defines a holder in due course as follows:

“Holder in due course means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque if payable to bearer, or the payee or endorsee thereof if payable to order, before the amount mentioned in it became payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.” Thus, a holder in due course is a person who :

1. is in possession of the instrument as defined in Section 8,
2. obtains possession of the instrument before maturity,
3. obtains possession of the instrument for valuable consideration (valuable consideration in the case of a negotiable instrument is always presumed until the contrary is proved),
4. is a holder, without having sufficient cause to believe that any defect existed in the title of the person from whom he received his title.

Here again the Negotiable Instruments Act differs slightly from the Bills of Exchange Act According to Section 29 of the Bills of Exchange Act:

“A holder in due course is a holder who has taken a complete and regular on the face of it, under the following conditions; namely, (a) That he became the holder of it before it was overdue and without notice that it had been previously dishonored, if such was the fact, (6) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.”

From the above definitions, it can be gleaned that a person who takes an instrument in good faith is a holder in due course, irrespective of whether or not he takes it negligently. In other words, the fact that a person has not exercised great caution or has not been negligent is not sufficient to dispute the title of the holder of a negotiable instrument, provided he has acted in good faith. However, according to the Indian Law, a person is a holder only if he takes the instrument, without having sufficient cause to believe that any defect existed in the title of the person from whom he received his title. This is, a person according to the Negotiable Instruments Act, is expected to take an instrument with reasonable care and without negligence.

A holder in due course obtains absolute title, even if he takes the instruments from a thief. All the previous parties to the instrument are liable to him. An exception to this general rule may be found when the instrument bears a forged signature of the true owner. The transferee of such an instrument does not get a valid title except in the case of an estopped.

This is a peculiar feature of a negotiable instrument which distinguishes it from ordinary debts and other properties. In the case of a negotiable instrument, the property in the instrument passes by mere delivery, or endorsement and delivery of the instrument, and a holder in due course takes the instrument free from the defects in the title of all the previous parties. In the case of other debts and properties, ownership can be transferred only by assignment, and the assignee acquires only the same title as was possessed by the assignor.

CHAPTER



PROMISSORY NOTES

Section 4 of the Negotiable Instruments Act, 1881 of India, defines a promissory note as :

“A promissory note is an instrument in writing (not being a banknote or currency-note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a, certain person, or to the order of the instrument.”

Examples :

- (a) “I promise to pay B or order Rs.. 420”.
- (b) “I acknowledge myself to be indebted to B in Rs. 1,000 to be paid on demand, for value received.”
- (c) “Mr. B, I.O.U. Rs. 1,000”.
- (d) “I promise to pay Mr. B Rs. 500, first deducting there out any money which he may owe me.”
- (e) “I promise to pay Mr. B Rs. 500 and all other sums which shall be due to him.”
- (f) “I promise to pay B Rs. 500 seven days after my marriage with C.”
- (g) “I promise to pay B Rs. 500 on D’s death, provided D leaves me enough to pay that sum”.

(h) "I promise to pay B Rs. 500 and to deliver to him my black horse on 1st January next."

The instruments respectively marked (a) and (b) are promissory notes. The instruments respectively marked (c), (d), (e) (f), (g) and (h) are not promissory notes.

Thus as in the case of a bill exchange a promissory note must be in writing and must be unconditional. Further, a promissory note must also be signed by the maker. It must be for a certain amount of money only. And it must be payable to or to the order, of a certain person.

Section 5 of the Act further elaborates "A promise to pay is not conditional within the meaning of this Section and Section 4, by reason of the time for payment of the amount or any installment thereof being expressed to be on the lapse of a certain period after the occurrence of a specified event which, according to the expectation of mankind, is certain to happen, although the time of its happening may be uncertain."

"The sum payable may be certain within the meaning of this Section and Section 4, although it includes future interest or is payable at an indicated rate of exchange, or is according to the course of exchange, and although the instrument provides that, on default of payment of an installment, the balance unpaid shall become due. "The person to whom it is clear that direction is given or that payment is to be made may be a certain person, within the meaning of this Section and Section 4, although he is misnamed or designated by description only."

Specimen Forms

Promissory Note Payable on Demand:

Stamp	New Delhi
Rs.. 420	23rd January 2009
On demand I promise to pay Mr..... or order the sum of Rupees four hundred twenty, value received(sd)	

Promissory Note Payable After Date with Interest:

Stamp	New Delhi
	23rd January 2009
Rs. 5,000	
One month after date I promise to pay Mr.....or of order the sum of Rupees Five Thousand with interest at the rate of 12% per annum until payment	
(sd)

Legal Decisions

The words "WHENEVER YOU DEMAND" does not make the undertaking a conditional one—It was held in *Jaggiwandas vs Gumanbhai* (AIR, 1967, Guj 1) that these words did not make the obligation of the executed of the instrument conditional upon the actual demand being made by person in whose favour the instrument was executed. The obligation arose as soon as the instrument was executed and those words were inserted merely in recognition of this obligation with a view to emphasizing that the amount should be payable immediately or forthwith. The net effect of these words was the same as that of their English equivalent, "I promise to pay you on demand" and if the latter words did not have the effect of restricting negotiability the former could not have that effect.

Another contention of the defendant in the instant case was that the name of the payee was not set out in the instrument, and all that the instrument said was, "We promise to pay whenever demanded by you;" the word "you" did not indicate a certain or definite person as the payee.

But the Court pointed out that section 4 of the Negotiable Instruments Act did not say that the name of the payee must be specified in the words of the promise nor did it say that the payee must be specified in any particular part of the instrument. The court further observed that the name of the payee might be set out on any part of the instrument and as long as it appeared clearly on a reading of the instrument taken as a whole that the instrument specified the

payee with certainty, the instrument must be held to be a promissory note, if the other ingredients of the definition were satisfied.

Negotiable instruments include promissory notes: but an instrument to be known as a promissory note need not be a negotiable instrument.—Negotiating the contention of the plaintiff that the instrument in question could not be considered a promissory note since according to the wording of the instrument it was not transferable and hence not a negotiable instrument, it was further held in the above case that the definition of a promissory note in Section 4 did not lay down any rule that an instrument in order to be a promissory note must be negotiable.

A document which is only a receipt enumerating the terms on which the amount is to be refunded must be distinguished from a document which is a promissory note.—But an acknowledgment of receipt of the amount will not exclude the document from the category of a promissory note. (Surjit Singh and Others Vs Ram Ratan Sharma—AIR, 1975, Gauhati 14)- In the instant case one of the partners of a firm had executed a document on behalf of the firm as follows: "We have received the sum of Rs. 9,240 from Shri Ram Ratan Sharma of Thanghal Bazar, Imphal. The above amount will be repaid on demand. We have received Rs. 9,240 in cash only."

According to Section 4 of the Negotiable Instruments Act, the High Courts observed that the essential ingredients of a promissory note were (a) that the promise to pay must be unconditional, (b) that the note must be in writing and signed by the maker, (c) that the promise to pay must be of a certain sum of money, and (d) that the promise to pay must be to or to the order of a certain person or to the bearer of the instrument. The High Court further pointed out that illustration (b) to the above section also showed that an acknowledgement of receipt of the amount did not take away the document from the category of a promissory note. Illustration (b) is thus: "I acknowledge myself to be indebted to B in Rs. 1,000 to be paid on demand, for value received". Therefore, the High Court held that the document in question was a promissory note.

Where a promissory note is executed by the managing partner of a firm, the other partners are also liable thereunder as makers.—

(Gurram Subbaravudu and Others Vs Moto Pothula Narasimham and Others—AIR, 1974, Andhra Pradesh, 307)—in this case a promissory note was executed on behalf of a firm by its managing partner in renewal of prior pronotes. The promise endorsed the same, for consideration, in favour of the endorsee, the endorsee filed a suit against 'the endorser as well as other partners of the said firm: the partners argued that the endorsee of the promissory note was not entitled to proceed against the non-executing partners and that since the endorsee did not obtain assignment of the debt, he was not entitled to plead any liability against any of the non-executants on the basis of the original debt.

The High Court observed that the executors or the maker of the pronote were always liable for the debt due under it. In view of Sections 5, 18, 19 and 22 of the Partnership Act, every partner was liable jointly with all other partners and also severally for all acts of the firm done while he was a partner. Since the pronote was executed by the managing partner and since the monies drawn were utilized for the purpose of the firm, every partner was liable. The High Court pointed out that under Section 16(2) of the Negotiable Instruments Act 1881 of India, the endorsee would stand, in the same footing as the payee, and under Section 50 of the Act the endorsement of a negotiable instrument followed by delivery would transfer to the endorsee the property therein with the right to further negotiation; but the endorsement may by express words restrict or exclude such right or may merely constitute the endorsee an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person. As there was no such restriction here, the endorsee was entitled to a decree against the partners of the firm for the amount due as those liable under the promissory note as makers.

An endorsee has a right to sue only the executant of a promissory note unless the endorsement is so worded as to transfer the debt, and the Stamp Law has also been complied with, in which case, he can also sue the non-executant co-partners of the executant also. (Chavali Kameswara Sarma Vs Mahankali Rajaratnam and Others—AIR, 1977, Andhra Pradesh, 60)—Briefly stated the facts of instant case are as follows: A had executed a promissory note in

favour of the father of B, who endorsed it in favour of B. Subsequently the father died leaving a will under which all properties not specifically mentioned in the will were bequeathed to B and his brothers. B re-endorsed the promissory note in favour of himself and his brothers, in a suit initiated by fi, the sons of A were also made defendants. But according to their contention the suit was not maintainable against them as they were not the executants of the promissory note. The suit was decreed in favour of B on the ground that in the instant case, the re-endorsement was in favour of the legal heirs of the original payee. The suit could be filed by them because the original payee could have filed the suit not only against the executant father but also against non-executant sons. In the course of the judgement the Learned Judge said:

“It is a fundamental principle of the law relating to negotiable instruments that no one whose name does not appear in the instrument can be held liable thereon, and there is no privity of contract between the endorsee and the maker or acceptor. Therefore, the right of the endorsee of the promissory note is limited to the remedy against the executant of the note. However, if the endorsement is so worded as to transfer the debt as well as the stamp law is complied with, the endorsee can sue the non-executant coparceners on the ground of their liability under the Hindu Law.”

As to the position of the endorsee of the promissory note in the case of transfer for collection, the Learned Judge observed:

“Although the endorsee of the promissory note would not be entitled to recover the debt from the shares of the coparceners of the family, yet if the endorsee retransfer the promissory note in favour of the original payee, a suit can be filed against the executant and the other members of the family to recover the debt from the shares of all the members.”

A person who is not a holder of a promissory note is not entitled to sue for the amount due thereon (Singheshwar Mandal Vs Smt. Gita Devi— AIR, 1975, Patna 81)—In this case the High Court observed that in terms of Section 78 of the Negotiable Instruments Act, payment of the amount due on a promissory note, in order to discharge the maker or acceptor, must be made to the holder of the

instrument The Act has defined a 'Holder' to mean a person entitled in his own name to the possession thereof and to receive or recover the amount thereon from the parties thereto. The plaintiff was not the holder of the promissory note in question. The plaintiff was also not a transferee of the debt or claim, since under the Transfer of Property Act, the transfer could be effected only by the execution of an instrument in writing signed by the transferor or his duly authorized agent, and no such instrument had been executed in favour of the plaintiff. The Court further held that the arrangement between the father of the plaintiff and the different members of the family consenting that the amount of the loan should go to the plaintiff, did not answer the requirements of law.

The liability on a promissory note is not affected by the body of the promissory note and the signature of the executant being in different ink (Ganga Singh Vs Peyar Singh and Others—AIR, 1972, Patna 216)—In this case, the High Court observed that it was immaterial if the body of the promissory note and the signature of the executant were in different ink. On the basis of the promissory note, the plaintiff was, *prima facie*, entitled to a decree in his favour, unless the defendants proved that the money due thereunder was paid or that the promissory note was executed without consideration.

Whether the assignor of a promissory note has a duty to indemnify the maker who is put to loss on account of the fraudulent act of the former—The question which came up for consideration in Arjuna Gounder and Another Vs Pillaiyar Gounder (1972,11, MLJ, Page 462) was whether the assignor has a duty to indemnify the maker or makers of a promissory note if an allegation has been made which would made the claim based on the same unenforceable.

In the instant case the makers of two promissory notes drawn in favour of G contended that these notes which are assigned in favour of P are not supported by consideration and hence unenforceable in law. They further contended that the assignor G is bound to indemnify the makers for any loss that may be caused to them as a result of the suit filed by the assignee P against them and therefore G should be made a party-defendant to the suits.

The lower court decided the case against the petitioners (makers) on the ground that they would not be entitled to be indemnified by the assignor. The Court relied on the observations made by Ramachandra Iyer, J in Pattabhiraman Vs Ganapathi Kannappa Mudali (1962, MLJ 246), viz..

“If the maker of a promissory note is made liable, he cannot proceed against the endorser as if the latter was a surety, as the liability under the note is always and ultimately that of the maker. Where the endorser negotiates a promissory note for the full value without giving credit to any payment that he might have received from the maker which are not endorsed on the note, the case in one where the payee or the endorser fraudulently negotiates the note for the full value. Therefore, the holder in due course in such an event cannot be prevented from collecting the money due on the promissory note according to its tenor and that, if the maker is put to a loss on account of the fraudulent act of the payee or endorser, his remedy would be only in the nature of damages and not amounting to an equitable claim of indemnity. The maker who is in the position of a principal debtor not having any right of indemnity against the original payee or endorser would not have any right to proceed against the latter.”

Thus, according to this judgement the only remedy open to the aggrieved maker of a promissory note is to file a separate suit for damages against the original payee or assignor.

This decision was challenged by the petitioners. It was observed in the appeal that ‘Ramachandra Iyer, J. has taken the view that the relationship between the maker and the endorser vis-a-vis the assignee is that of a principal debtor and a surety; that where the assignee has recovered the money from the endorser, the latter as surety has had a right of recourse for indemnity to the maker and that in the converse case where the assignee had recovered the money from the maker, the latter had no such right of recourse to the endorser. The Learned Judge continued to observe that the fact that there was no contractual liability on the part of the endorser to indemnify the aggrieved maker did not necessarily mean that there was no equitable obligation on the part of the erring endorser to

indemnify, that is, to compensate, the maker for the loss and damage sustained by him as a result of his action. It is true that the endorser who negotiates the promissory note for the full value without giving credit to any payment that he might have received from the maker, may be said to have fraudulently negotiated the note for the full value and that the maker in such an event would have a remedy in the nature of damages but it will be difficult to say that he had no equitable duty to indemnify the aggrieved maker. The Learned Judge in the instant case felt that in view of the serious averments made *viz.*, the promissory notes have become unenforceable in law, for want of consideration, it would be necessary and proper to impale the assignor who has an equitable duty to indemnify, in the circumstances of the case, the makers, instead of driving the parties to agitate their rights in a separate suit

Negligence of the maker of a promissory note and the loss suffered by the endorsee—Where the maker of a promissory note fails to get partial discharge of the principal amount endorsed on the promissory note and where an endorsee has no knowledge about the partial discharge, he will become liable to pay the endorsee the entire amount under the same. Although the maker may take appropriate steps for refund of the said amount from the original payee, he will have to suffer for the consequential losses as against the endorsee. (*S.W. Ashirvadam and Another Vs Palniraju Mudaliar*—AIR, 1973, Mad. 439). In the instant case it has also been held that the mere fact that the promissory note was endorsed long after its execution will not bar the endorsee from becoming a holder in due course.

The decision in *Srinivasa Gounder Vs Kannu Gounder* (AIR, 1966, Madras 176) was also similar to that in the case stated above. Here the High Court held that there was clear negligence on the part of the maker, in paying the endorser without calling back the promissory note, he could not be allowed to plead against a holder in due course absence of notice of the transfer. Since the maker had, by his omission to demand delivery of the note when he paid the original payee, enabled the original payee to receive payment to the detriment of the endorsee, the maker must bear the loss suffered by the endorsee.

Any alteration of a promissory note by the promise inserting rate of interest would amount to a material alteration vitiating the instrument—It has been held in *Seth Tulsidoss Lalchand Vis G.Rajagopal* (1967, 11, MLJ. 66) that even though the law provides that where a promissory note does not express the rate of interest payable thereon, six per cent interest shall be payable under Section 80 of the Negotiable Instruments Act, any alteration of the instrument by the promise inserting rate of interest would amount to a material alteration vitiating the instrument.

The facts of the instant case briefly discussed as follows: A money lender filed a suit on a promissory note which was on a printed form. The blank space in the promissory note had been filled up by the money lender showing the rate of interest at one per cent per month. According to the debtor this was a material alteration and hence no suit would lie on the instrument.

The contention of the money lender was that Section 20 of the Negotiable Instruments Act allowed to fill up the pronote as regards the rate of interest, as but for that, the document would be an incomplete instrument. According to Section 20, where one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instruments then in force in India and either wholly blank or having written thereon an incomplete instrument he thereby gives prima facie authority to the holder thereof to make or complete as the case may be, not exceeding the amount covered by stamp, and that the person so signing shall be liable upon the same in the capacity in which he signed the same. This argument, however, was opposed on the ground that Section 80 of the Act provides that where no rate of interest is mentioned, six per cent would be deemed to be the rate of interest payable, and therefore, a pronote, which does not mention the rate of interest payable thereon, cannot be said to be an incomplete instrument and, consequently a promise has no authority to fill up the pronote with regard to the rate of interest and if he does so, it would amount to material alteration.

Negotiable instruments must come into existence for the purpose only of recording an agreement to pay money and nothing more,

though, of course, they may state the consideration—In *Dickie Vs Singh* (1974, SLT (Notes) 3) one of the points which came up for consideration was whether the document in the following form was a promissory note:

I, X, do hereby agree to pay Y the sum of £ 950 to be paid at the rate of £ 50 per month. First payment on the first day of every month commencing 1 February 1969. Also the present staff to be employed by myself for the next two weeks (from 20 January 1969).

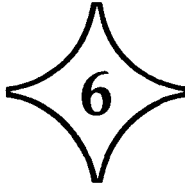
It had been argued that the document in question was not a promissory note since the last sentence of the document promised the performance of an act in addition to the payment of money.

It was decided that the document was not a promissory note. The Learned Judge pointed out that the matter had been put beyond doubt by a passage in the judgement of the Privy Council in *Nawab Major Sir Mohammed Akbar Khan Vs Attar Singh* (1936, 2 all, E.R. 545) wherein it was stated that negotiable instruments must come into existence for the purpose only of recording an agreement to pay money and nothing more, though, of course, they may state the consideration.

The practical importance of this decision stems from the fact that bankers often grant credit facilities on the basis of documents which contain promise to pay money on stated dates. Some of these documents are lengthy and the banker has to ensure that they do not contain any provision which may take them out of the category of promissory notes as otherwise the banker may find that it will be unable to enforce rights against the concerned parties.

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CHAPTER



ENDORSEMENTS AND CROSSINGS

An endorsement means the signatures of a payee or parties subsequent thereto, on a negotiable instrument, for the purpose of transferring the property vested therein. For example, an order cheque may first be endorsed and, then delivered to a third person for transferring the property; vested therein to such a person. An endorsement consists of following two parts : (a) the pay order, containing the name of the endorsee; and (b) the signature of endorser below the pay order. A pay order should unconditionally convey full rights to the endorsee.

Types of Endorsements :

Endorsements are of following two types : (i) Blank Endorsements, and (ii) Full or Special Endorsements.

A Blank Endorsement : An endorsement where a payee (or any endorsee, *i.e.*, the party subsequent there to) puts his signatures without writing any pay order is called a Blank Endorsement. A payee is a person to whom or to whose order the amount mentioned in a cheque is payable. An endorsee, on the other hand, is a person, in whose name a cheque has been subsequently endorsed.

If a cheque has been endorsed in blank, it becomes payable to the bearer even though it might have been originally made payable to the order of a certain person. For transferring the title of a cheque, which has been endorsed in blank, no endorsement by any subsequent party is necessary. But if a blank endorsement is followed by a full endorsement, the cheque again becomes payable to the order of the person whose name has been mentioned in the special endorsement.

A Special or Full Endorsement : If in an endorsement, a payee or endorser specifically mentions that the instrument is payable to a specific person or to his order, the endorsement is called a Full or Special Endorsement. A Full or Special Endorsement contains both the parts of an endorsement, *i.e.*, (i) pay order, purporting to convey unconditional rights to the endorsee, and (ii) the signatures of the payee or endorser. Illustrations of full or special endorsements are:

- (1) Pay to Mr. Ramesh Singh or Order
Sd/- Rajeev Sharma
- (2) Pay to M/s. Gupta Enterprises, For Mehra & Co.
Sd/- Subhash Sharma
Proprietor

Endorsements in Different Cases :

The property in respect of a Negotiable Instrument, payable to the order of a certain person, is transferred to another person by endorsement and delivery. If an endorsement is defective, the transfer of the title itself may become defective and, as such, the payment by a banker against such an instrument to the payee/endorsee may not be deemed as payment in due course. Some rules which should be followed while making endorsements in different cases are given in the following paragraphs:

(1) **Endorsements in case of Bearer cheques :** In U.K., a payee's discharge is not insisted in case of a bearer cheque. In India the practice, however, is to insist for the payee's discharge before making payment. If a payee refuses to give a discharge to the paying bank, he may be asked to give a stamped receipt for the amount involved. The identification of a payee cannot be insisted in bearer cheques.

However, if the amount payable is large, the drawer of the cheque may be contacted for verification, in case of doubt. For bearer cheques, the rule is "Once a bearer, always a bearer". According to the Negotiable Instruments Act. "Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer there of, notwithstanding any endorsement whether in full or in blank, appearing there on and not with standing that any such endorsement purports to restrict or exclude further negotiation.

This rule, however, does not apply to bearer cheques marked "Account Payee". Such an instrument should be credited to the account of the payee only. Similarly, if a bearer cheque is payable to a limited company or a corporation, as a matter of practice, banks do not treat such cheques as payable to bearer, nor is cash paid against such instruments. Such cheques are, ordinarily, credited to the account of the company or corporation only.

(2) *Endorsements in Order cheques* : An order cheque requires to be endorsed and delivered to the endorsee for transferring the property vested therein. If an order cheque is presented for payment, the payee's discharge may be insisted upon in token of the receipt of payment. If the payee refuses to give a discharge, a stamped receipt for the amount may be taken in lieu thereof.

(3) *Endorsements in case of individuals* : Order cheques, where the payee/ endorsee is an individual, should be endorsed as per rules given here under :

(i) *A cheque payable to two or more persons* : If a cheque is payable to two or more persons jointly, all such persons must separately endorse the cheque. If a person has been authorized to sign on behalf of the other, and the banker has knowledge of such an authority, or a satisfactory proof of such an authority is produced, the person holding the authority can endorse a cheque on his own behalf as well as on behalf of the other.

(ii) *Where a person signs on behalf of another* : A person who is signing on behalf of another should mention the capacity in which he is signing, and should so indicate before writing the name of the payee on whose behalf he is signing.

<i>Example</i>	<i>Wrong Endorsement</i>	<i>Correct Endorsement</i>
Rajeev Sharma, endorsing on behalf of Vijay Gupta.	pp Vijay Gupta Rajeev Sharma	per pro Vijay Gupta (Sd/-) Rajeev Sharma Duly Constituted Attorney

(iii) *Where courtesy title is added* : The practice is to ignore such a title while making an endorsement. But there is no harm if the courtesy title is suffixed in the endorsement.

<i>Example</i>	<i>Wrong endorsement</i>	<i>Correct endorsement</i>
(i) Rai Bahadur Ravi Prakash	R.B.Ravi Prakash	Ravi Prakash
(ii) Lt.Col.P. Banerjee	Lt.Col.P.Banerjee	P.Banerjee,Lt.Col.

(iv) *Where designation is added* : After the endorsement, the designation may be added or omitted, at the option of the payee/endorsee.

<i>Example</i>	<i>Wrong Endorsement</i>	<i>Correct Endorsement</i>
Principal S. Bannerjee	Principal S.Banner- jee	S. Bannerjee, Principal, Delhi Institute of Technology, Delhi

(v) *Where name is wrongly spelt* : Correctly spelled name should appear in bracket in addition to an endorsement made exactly in the style in which the name appears on the cheque. The main endorsement should agree letter by letter with name as appearing in a cheque.

<i>Example</i>	<i>Wrong Endorsement</i>	<i>Correct Endorsement</i>
N.Kapoor, but wrongly spelled the cheque	(i) N.Kapoor (ii) N. Kapur	N.Kapur (N.Kapoor)

(4) *Endorsements in case of Firms* : An endorsement on behalf of a firm can be made by its proprietor or any of its partners. Other employees, such as, Manager, etc., can endorse on behalf of a firm if the bank has knowledge of the authority of such a person. However, such an endorsement should make it apparent that the person concerned is signing on behalf of the firm, indicating therein the capacity in which he is signing.

Example	Wrong Endorsement	Correct Endorsement
M/s. Shroff & Co.	Vijay Rastogi for Shroff & Co.	For Shroff & Co. Sd/-Vijay Rastogi Partner

(5) *Endorsements in Case of Trusts* : A cheque payable to a trust should be endorsed by all trustees. Per Pro endorsement, or an endorsement by one of the trustees on behalf of others is not acceptable. All trustees should sign individually before writing the name of the trust.

Example	Wrong Endorsement	Correct Endorsement
Swarg Ashram	(i) For Swarg Ashram Trust Sd/- N. Sigh Manager (ii) For Swarg Ashram Trust, For Self and other Trustees, Sd/-Sant Singh Trustee	For Swarg Ashram Trust, Sant Singh, Deep Rao, D.B. .Garg, Trustees

(6) *Endorsements in Case of Married Ladies* : Order cheques in the names of married ladies should be endorsed as per rules given hereunder.

(i) *Where a cheque uses the name of husband, instead of the actual name of a married lady* : In such cases, the woman concerned should sign her name, and words "wife of Mr. so and so", *i.e.*, name of the husband as given in the cheque should be added.

Example	Wrong Endorsement	Correct Endorsement
Mrs. S.K. Sharma	(i) Radha Sharma (ii) S.K.Sharma (Mrs.) (iii) Mrs. S.K. Sharma	Radha Sharma, wife of Mr.S.K. Sharma

(ii) *Where courtsey title is added* : Simple signatures are

Example	Wrong Endorsement	Correct Endorsement
Shrimati Mehta	Smt. Mehta	Sapna Mehta

(iii) *Where cheque is in the maiden name of a married woman* : The maiden name should be given in brackets prefixed by word "Nee", in addition to an endorsement in the post-marriage name of the lady.

<i>Exemplé</i>	<i>Wrong Endorsement</i>	<i>Correct Endorsement</i>
Payable to Miss Sapna Mehta (name after marriage, Manju Khandelwal)	(i) Sapna Mehta (ii) Manju Khandelwal	Manju Khandelwal (Nee Sapna Mehta)

(7) *Endorsement in Case of Public Limited Companies* : An authorized official should sign "for and on behalf of" the company, mentioning the capacity in which he is signing under his signatures. Endorsements made by Directors Managers and Secretaries are accepted by banks in normal course. But endorsements by other officials on behalf of a company should be accepted only if a banker has knowledge of authority of such a Person.

Per Pro Endorsement :

While endorsing a negotiable instrument on behalf of a principal, an agent must make it clear that he is doing so on behalf of the principal. For this purpose, terms, such as, 'Per Procreation', 'Per Pro', 'On behalf of', 'For', 'For and on behalf of' are used. In such an endorsement, the capacity in which the signatures are being put should be stated. The inclusion of such words in an endorsement, gives an indication to all concerned that the authority of the signatory is limited. Any person who accepts an instrument drawn, accepted, or endorsed by such a person should satisfy himself about the extent of authority of the person signing.

If a bank pays an instrument so drawn, accepted or endorsed in 'good faith', 'without negligence', and 'in ordinary course of business', it does not run any special risk. But, if there are reasons to suspect 'the authority of a person so signing, the bank is expected to be vigilant. In case of any doubt, a banker should verify the nature of authority delegated to such a person by the principal.

Simple Endorsement :

If in a full endorsement, the endorsee is a single individual, the endorsement is called a simple endorsement, example, 'Pay to X', or 'Pay to X or order'.

Joint Endorsement :

Where an instrument is endorsed in names of two or more persons, the endorsement is called a 'Joint Endorsement' Such an

instrument requires to be discharged separately by all the endorsees. Examples of joint endorsements are :

- (1) Pay to X and Y jointly;
- (2) Pay to X and Y or their Joint order; or
- (3) Pay to X and Y and Z or order,

Ambiguous Endorsement :

An endorsement is an ambiguous endorsement, if the name of the endorsee is not clearly ascertainable, or where several different persons can be interpreted to be the endorsees. For example, let us examine an endorsement reading, "Pay to A or B and C". In this case, there can be, at least, three different interpretations of the pay order. The endorsee can be either (i) A, or (ii) B and C jointly, or (iii) A and C jointly. An endorsement, where the intention of the payee/endorser is ambiguous, is called an ambiguous endorsement. An ambiguous endorsement should be got amended by the payee/endorser under full signatures.

Alternative Endorsement :

Where an instrument is payable to either or any of endorsees, the endorsement is called alternative endorsement. Examples of such an endorsement are :

- (1) Pay to X or Y or order,
- (2) Pay to X,Y,Z,or any one, or more of them, or
- (3) Pay to X or Y.

Crossing of a Cheque :

A cheque may be open or a crossed one. An open cheque is a cheque without any crossing. Such a cheque can be paid in cash on presentation at the counter, either to the bearer or to the person specified in the instrument or his order. But, if a cheque is a crossed one, its payment cannot be made in cash over the paying bank's counters. A crossed cheque, on the other hand, requires to be collected through the payee's bank, called the collecting bank. A crossing, therefore, is a direction to a paying banker to ensure that the cheque may be paid only if presented through a bank.

Significance of a Crossing : During the course of its collection, an open or uncrossed cheque runs the risk of being lost and its payment being obtained by a person who may not be its rightful owner. The object of a crossing is not to restrict the negotiability of a cheque, but to ensure that the transaction is routed through a bank-an act which reduces the risk by enabling all concerned to locate the person who has received the payment. A cheque, which is originally crossed, can be paid over the counter if the crossing is cancelled. But, while paying such a cheque, bank should be extra cautious.

Different types of crossings :

Crossings are, primarily, of three different types ; (i) General; (ii) Special, and (iii) Restrictive.

(1) General Crossings : “Where a cheque bears across its face an addition of the words “and company” or any abbreviation thereof, between two parallel transverse lines, or two parallel transverse lines simply, either with or without the words “not negotiable”, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally”. A few illustrations of General Crossing are :

- (i)
- (ii) & Co.
- (iii) & Company
- (iv) Not Negotiable
- (v) Not Negotiable & Company

(ii) Special Crossings : “Where a cheque bears across its face an addition of the name of-a banker, either with or without words “not negotiable”, that additions shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be crossed to that banker”. A few illustrations of Special Crossings are :

- (i) State Bank of India
- (ii) United Commercial Bank
- (iii) State Bank of India -Not Negotiable

(iii) Restrictive Crossings : Sometimes, a few additional words may be added to a crossing with the purpose of further restricting its negotiability and thereby reducing the risk of the cheque being paid to a person who is not its rightful owner. Such restrictive crossings are not listed in the banking law, but courts treat them as valid directions as from the holder to the banker. A few examples of such crossings are :

- (i) Account Payee only
- (ii) A/C Payee only Not negotiable
- (iii) S.B.I. A/C Hindustan Machine Tools

An Account Payee Crossing : The Negotiable Instruments Act, 1881, does not recognize the 'Account Payee' crossing. Whereas the Act deals with the General, Special and 'Not Negotiable' crossings, it is silent about 'Account Payee' Crossing. But an "Account Payee" crossing has been so widespread in practice, and has been in vogue for such a long time, that it has been accepted as valid by courts. (Tailors Priya Vs. Gulab Chand Dauraj, AIR, 1963)

Such a crossing is, in fact, not a mandate to the Paying bank, but is type of a direction to the Collecting bank to ensure that the amount of a cheque so marked is collected only for the credit of the payee's account. If a collecting bank ignores such a direction, it can be held negligent and, therefore, made liable for conversion to the true owner of the cheque. It is immaterial whether the cheque is a bearer or an order one. If a collecting bank has to collect such a cheque for a person other than the payee, such a course should be adopted only after a reasonable inquiry. It would, however, be in order for the paying bank to pay-such a cheque, if payable to bearer, with or without any confirmation/endorsement from the collecting bank. But if, in an order cheque marked 'Account Payee', it is apparent that the collecting bank is collecting the cheque for a third person, the same may be returned by the paying bank with the objection, "Cheque is marked Account Payee. The Collecting Bank's Confirmation Required". If the collecting bank confirms such an endorsement, or simply represents such a cheque for payment, the paying banker is justified in paying the cheque.

A **“Not Negotiable” Crossing** : The addition of words, ‘Not Negotiable’ in a crossing does not prohibit the negotiability of an instrument. These words imply that holder of an instrument marked “Not Negotiable”, shall not have, and shall not be capable of giving, a better title on the cheque than the one held by person from whom he took it. Under Negotiable Instruments Act, 1881, certain protection is available to a “holder in due course” who gets a title better than the one possessed by the endorser. But, the title of a holder in due course would remain defective if the instrument is marked ‘not negotiable’. In ‘not negotiable’ instruments, the transferability of an instrument is not prohibited, but is restricted. ‘Not Negotiable’ crossing provides greater safety to a drawer, a payee, or parties prior to the holder. The banks should be cautious while handling cheques bearing such a crossings.

Duties and Responsibilities of a Paying Banker :

When a bank opens an account, the contractual relationship between the banker and his customer begins. The bank on its part, is obliged to make payment of customer’s cheques, drawn on his account, unless there are valid reasons for not doing so. The bank who is obliged to pay the cheque of a customer is called the ‘Paying Bank’. If a paying bank wrongly dishonours a customer’s cheque, it may be required to pay damages for adversely affecting his credit. A bank has to honour a customer’s cheque provided the conditions noted in following paragraphs are fulfilled.

(1) **Sufficient Credit Balance** : If a customer has sufficient credit balance in his account, or has otherwise made some arrangements with the bank for honouring his cheques, the latter would be liable for wrongful dishonours to the former if it returns his cheques. In case of shortage of funds in an account, a wise banker would return the cheque with, “present again” memorandum, provided there is a likely hood of the customer putting adequate credit into his account at an early date, or if some of the instruments lodged by the customer are in the process of collection. A customer is, however, not entitled to draw cheques against a Cheque/ Bill, or any other instrument sent for collection, unless such an arrangement exists between him and the bank. Further a bank has a right to set-off the credit balance

of customer's account against the debit balance of another account maintained by the same customer. This right, of course, should be exercised only after giving due notice to the customer. A bank, however, is not entitled to earmark some amount for a lien marked in an account for meeting any contingent liability and return a cheque for want of funds.

(2) **Cheque is Properly Drawn** : If a cheque is properly drawn, bank is obliged to honour it. A cheque is deemed to be correctly drawn, if it satisfies under-noted conditions :

- (a) Signatures on a cheque agree with those given to the Bank:
To enable a bank to satisfy itself about the genuineness of a cheque or a signature, the signatures of a customer, or his duly constituted attorney, must be in strict conformity with those signatures which were recorded in the Specimen Signature Sheet at the time of opening of the account. If signatures of a customer are different, the bank should not pay the cheque. In fact, in such a case, the bank does not get a valid mandate from the customer to debit his account. But, if by his conduct or otherwise, a customer induces the bank to believe in the genuineness of a particular signature, the customer cannot, at a later stage, dispute the bank's right to debit his account on the ground of the forgery in signatures.
- (b) The amount in words and figures agree : As per law, a bank can pay the amount as expressed in words, but in practice, banks return a cheque in which the amount written in words and figures differ. Evidently, such a cheque does not give a clear mandate to the bank.
- (c) Cheque is dated, not being post-dated or stale: If a cheque is post-dated, or has become stale, *i.e.* has not been presented with a period of six months from the date of its making, the banks return such a cheque, unless in the meantime, an advice to honour it is received from the customer.
- (d) Cheque is unambiguous : The customer's mandate should be un-ambiguous. If it is doubtful as to whether a particular

instrument may or may not be regarded a cheque in the eyes of law, the bank is justified in returning such an instrument.

- (e) A crossed cheque is presented through a bank: If a cheque is a crossed one, it can be collected through a bank only. If a cheque has been crossed specially, it should be collected through the specified bank. If a cheque bears double crossing, *i.e.*, it has been crossed to two banks, it may be returned. A cheque crossed to two banks can be paid only if a bank is acting as agent for collection on behalf of the other. A collecting bank can, of course, present a crossed cheque for cash payment to the paying bank.
- (f) Amount is not chemically or fraudulently altered: If a bank has paid a cheque, where the fraudulent alteration could have been detected by an exercise of reasonable diligence and care, the bank is not entitled to debit the customer's account. But, if such an alteration is not apparent, and the payment of the instrument has been made by a bank, in good faith and without negligence, or if it is found that the actions of the customer have somehow facilitated in the fraudulent manipulation of the cheque, it is the customer who will have to suffer the loss.
- (g) Cheque bears correct endorsements : Endorsements appearing on a cheque should be, *prima facie*, in order. If, any endorsement appearing on a cheque is 'apparently' not in order, the bank is justified in returning the cheque.

(3) ***Cheque is Drawn on the Branch where Presented for Payment:*** A cheque must be presented for payment at a particular branch of a bank where a customer maintains an account; otherwise, such a cheque would be returned. A cheque drawn on a branch of a bank cannot be presented for payment to another branch, or to its Head office.

(4) ***Cheque is Presented within Banking Hours :*** A cheque should be presented for payment to a Paying Bank within the usual business hours. A Paying bank cannot be held liable for not paying a cheque which has been presented for payment after the usual business hours.

Statutory Protection Available to a Paying Banker :

Every bank, during the normal course of its business operations, handles large number of cheques and other negotiable instruments. At the same time, it is expected to ensure that the payment of an instrument is given only to a true owner; otherwise, it may be held liable for conversion.

An absolute implementation of this responsibility would have hindered the working of banking industry, and created numerous bottlenecks in the smooth functioning of the economy. For this reason, the Negotiable Instruments Act provides some Statutory Protection to a paying banker. Referring to Order Cheques, Section 85(1) of Negotiable Instruments Act provides, "Where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course". This provision applies equally to subsequent endorsements. Similarly, for bearer cheques, Section 85(2) of the Act provides, "Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any endorsement appearing thereon, and notwithstanding that any such endorsement purports to restrict or exclude further negotiation". The statutory protection available to a Paying banker for drafts is, more or less, identical to the one available in case of the Order Cheques.

Thus, according to the Negotiable Instruments Act, 1881, if the title of a person who has received payment of a cheque or a draft, subsequently proves to be defect, the paying banker is protected provided the payment has been made :

- (a) in accordance with the apparent tenor of the instrument;
- (b) in good faith;
- (c) without negligence; and
- (d) under circumstances which do not afford a reasonable ground for believing that the person receiving the payment is not entitled to receive the amount of the instrument.

A brief explanation of each of above points is given below :

(a) *In accordance with the Apparent tenor of the Instrument* : If a post-dated or a stale cheque, or a cheque having some apparent

mistake or short-coming has been paid, the payment would not be regarded as 'payment according to the apparent tenor of the instrument'. In such cases, the statutory protection would not be available to the paying bank.

(b) *Payment is Made in Good Faith* : The bank should not have any direct, or indirect hand or involvement in the payment of the cheque. For example, if a cheque has been paid after business hours in next day's date, the payment would not be in 'good faith'. The statutory protection would not, therefore, be available to the paying bank in this case.

(c) *Payment is Made without Negligence* : The statutory protection would not be available to a paying bank if it is found negligent while making payment.

(d) *No reasons to Believe that the Person Receiving Payment is not Entitled to do so* : For example, if a bank was somehow informed of the theft of a particular cheque it would not be in a position to claim protection if the payment has been made to a wrongful owner without exercising due care .

Mistaken Payment :

If a bank has credited certain amount into a customer's account by mistake, such an entry can be reversed and the amount recovered. But in certain cases, which are noted below, the amount may not be recoverable :

- (i) if the payee, is complete innocent of the wrong payment, has altered the position to his detriment, *i.e.*, may have delivered goods against the receipt of payment, or may have issued cheques relying on the credit.
- (ii) If a payee on receipt of an amount, acting as agent, has, in turn, passed it to the principal.

The payments credited into a customer's account without intimation to him, or where a beneficiary has no knowledge of a transaction, can be reversed by a bank without incurring any liability.

Payment of a Chemically Altered Cheque :

According to Negotiable Instruments Act, if a bank has paid a cheque, which is chemically altered, it would be protected if :

- (i) the payment was made in due course, *i.e.*, in good faith and without negligence. If a chemical alteration was not apparent at the time of payment, the bank is protected.
- (ii) the payment was made in circumstances which did not afford reasonable grounds for believing that the person receiving payment was not entitled to receive it.

In U.K., the position is different. There, a customer will have to bear the loss only if it is suffered due to his negligence; in other cases, it is the bank which bears the loss.

Material Alteration in a Negotiable Instrument :

Any alteration in a negotiable instrument, which introduces basic changes in the instrument, such as, alteration in date, or place of payment, or amount payable, or mode of payment, or rate of interest, or its legal character is called a material alteration. A material alteration in an instrument can be made by its maker. Such an alteration, if made by a holder is also permitted, if it is made for carrying out the common intention of the original parties; otherwise, the prior parties liable on the instrument, who have not consented to such an alteration, are discharged. Under-noted alterations/additions in an instrument are not treated as material alterations:

- (i) filling up blanks in an instrument;
- (ii) converting a blank endorsement into a full endorsement;
- (iii) crossing a cheque, including converting a general crossing into a special crossing;
- (iv) qualifying an acceptance; or
- (v) any alteration made innocently or accidentally.

Stop Payment of a Cheque :

Only the drawer of a cheque has a right to stop its payment, which should be done in writing. In accounts other than those of individuals, instructions regarding stop payment of a cheque should be given by a person who is authorized to operate the account. A

notice countermanding the payment of a cheque cannot be conveyed through phone or through a telegram. In such cases, it may be difficult to establish the authenticity of such an instruction. But, such a notice, even though received through telephone or telegram in certain circumstances, should put the bank on its guards. The bank, in cases like theft or loss of an instrument, should take more than ordinary care while handing such an instrument.

The letter countermanding the payment of a cheque must describe the same with reasonable accuracy. If a bank pays a cheque because of certain discrepancies between the description of a cheque on the stop letter and the cheque itself, it cannot be held negligent for paying the cheque. If a letter describes a cheque, whose payment is sought to be stopped, accurately, the bank would be liable for paying the cheque, notwithstanding an intimation, disowning such a responsibility, which is usually sent to the customers.

Marking a Cheque :

Many a time, a customer may request his banker to 'mark' or 'certify' a cheque as 'good for payment'. This favour is usually sought, when a large sum is involved, or when adequate rapport between a buyer and a seller is not existing. By getting a cheque marked "good for payment" by the bank, the seller (who is a payee) is assured of the payment of the cheque.

The practice of marking a cheque 'good for payment' is usually discouraged by banks. If a cheque is marked 'good for payment', the bank is justified in recording a lien for the amount in customer's account. By the very nature of the transaction, a banker would certainly be under some sort of obligation to pay a cheque so marked. The bank's position would, however, become difficult, if another cheque disturbing the lien, is presented for payment before the presentation of the marked cheque. The bank would not be justified in returning the cheque which has been, in the meantime, presented for payment.

Teller System :

The regular banking procedure for cash payment of a cheque, issue of a receipt for a cash deposit, or for a transfer deposit involves

considerable delay for the customers. Particularly, at a large branch, such a process involves time, which is very irritating to a customer, more so when the amount involved is small.

Under the Teller system, a customer gets ready cash of a cheque, up to a specified limit from the cashier who is termed as Teller. The entire procedure is completed subsequently. In few banks, the Cashier/Teller does not keep any signature or copy of the account. When in doubt, he is expected to refer to the ledger or the signature binder. As the amount involved in such cases is small, and as with experience, the paying cashier is likely to familiarize himself with the signatures of most of the customers, only a negligible risk is involved so far as the bank as a whole is concerned.

There is another type of teller-system prevalent in few banks. Under this Teller system, a duplicate signature card as well as a copy of the customer's account is available with the Teller. The Teller makes payment after making a reference to the duplicate records.

Mobile Banks :

A mobile bank is a 'Bank on Wheels'. An arrangement is made for providing most of the routine banking facilities on a mobile van, which visits different pockets of population on different appointed day or days of a week. When the business potential at a center is not adequate to sustain a branch or a sub-office of a bank, the mobile vans can be gainfully used for enlarging banking facilities in the country. This arrangement is particularly suitable for catering to the needs of rural centers. Several villages or pockets of population can be served with the help of one mobile van.

A mobile bank performs several functions of a routine nature, such as, accepting time and demand deposits, issuing drafts, receiving bills and other instruments for collection, and at times, making small loans.

The Mobile Banks have rendered significant service in extension of banking facilities in rural areas, and in mobilising rural deposits. Even at urban centers, mobile vans have been helpful in providing banking services to a 'certain, group of persons at their door-steps,

e.g., to workers of a factory, or employees of an organisation. This device saves a lot of trouble and time of the customers who are sought to be served.

Duties and Responsibilities of a Collecting Bank :

One of the important duties and responsibilities of a bank as agent of a customer, is to collect cheques and other instruments on his behalf. While doing so, a bank has to act in 'good faith' and 'without negligence'. Section 131 of Negotiable Instruments Act, 1881 provides that a bank who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment". Such protection is available in case of drafts, cheques and other instruments, collected, purchased or negotiated by a bank. To get the statutory protection available under Negotiable Instruments Act, it is necessary that the collecting bank collects the instruments on behalf of his customer, (a) 'in good faith', and (b) 'without negligence'. The conditions which should exist to enable a collecting bank to get the statutory protection are discussed below.

(1) ***Collection should be in good faith*** : The courts presume that a bank has acted in good faith. The burden of proof for proving that a bank did not act in good faith is on the person who has suffered the loss.

(2) ***No Negligence should be involved*** : The courts have, however, interpreted the term 'negligence' widely. They not only examine a particular transaction, but go into the conduct of the entire account, right from the time of its opening. Some of the grounds on which the banks have been found negligent are given below :

- (a) Where an introductory reference was not obtained, or where necessary follow-up for verification of the introduction was not done;
- (b) where name of the employer or a prospective customer or, in case of a lady, name of her husband was not ascertained and recorded;

- (c) where a cheque drawn in favour of, or drawn by a limited company was credited to the account of a director or an employee of the company without due inquiry;
- (d) where a cheque drawn in favour of a partnership was credited into an account of a partner without proper inquiry;
- (e) where a cheque, sent for collection, was apparently not in order.

(3) Instrument should be Collected for a Customer only : The Instruments should be collected by a bank for customers only. A person becomes a customer of a bank, the moment his opening form is accepted by the letter. Even in cases where the first credit into an account is by means of a cheque, the statutory protection is available to the Collecting bank.

Clearing House System :

A bank has to collect several cheques drawn on local banks on behalf of its customers, other branches of same bank, and other banks. For obtaining payment for such cheque; the bank will have to send its employees to different local banks to collect proceeds. Similarly, all other banks will have to send their representatives to different banks for obtaining proceeds of their cheques. Such a course of action would, necessarily, involve substantial time, money and labour on the part of all the banks. This wastage of men, money and material can be avoided by resorting to what is called 'Clearing House System'.

Under Clearing House System, the representatives of different local banks assemble at one place and settle transactions between themselves by exchanging such instruments. Incidentally, another important advantage accrues from the system. Instead of arranging money for all instruments drawn on it and then collecting proceeds of cheques presented, a bank is required to arrange money only to the extent of the difference between the aggregate amount of cheques presented and received for payment.

Who Conducts the Clearing House? : The arrangements for conduct of the Collecting House are made by Reserve Bank of India. As Reserve Bank of India has branches at few centers only, in most

of the cities such arrangements are made by State Bank of India or its subsidiaries as agents of the former. With nationalization of commercial banks, this responsibility is being entrusted to a few nationalised banks at some centers.

How is Clearing done? : The accounts of the Clearing House and the member banks are maintained at the bank, which makes Clearing House arrangements. The aggregate amount of cheques presented by a bank in the Clearing House is debited to the account of Clearing House, and credited to the account of the presenting Bank. Similarly, aggregate amount of cheques payable by a bank, presented by different banks, is debited to the account of paying bank, and credited to the account of Clearing House. The net result of the debit and credit transactions routed through these Clearing Accounts, on a particular day, would be nil.

If business handled by a bank is small, it need not become a full-fledged member of the clearing house. Such a bank can be admitted as a Sub-member of the clearing house, its interest being represented by a member-bank.

As regards cheques returned unpaid, the clearing house meets for a second time when the above procedure is repeated. The aggregate amount of cheques returned is debited to the account of clearing house and credited to the account of the returning bank. Similarly, the amount of cheques presented by bank, returned unpaid, is debited to the account of concerned presenting bank and credited to the account of the clearing house. Net result of the transactions resulting from the second clearing is, again, nil.

If the number of returned cheques is negligible at a center, it may not be necessary to have a second sitting of the clearing house. At such centers, the banks send return cheques direct to the presenting bank, and get pay order in lieu thereof. Even at centers where the Clearing House is meeting for a second time, the cheques returned unpaid after the hours fixed for second clearing, are sent direct to the presenting bank.

The detailed rules regarding the conduct of 'clearing' at a center are decided in the meeting of various member banks, wherein local problems are kept in view.

The RBI views the four new measure of money stock to represent different degrees of liquidity. It has specified them in the descending order of liquidity, M_1 being the most liquid and M_4 the least liquid of the four measures.

Which of the alternative measures of money supply to choose and why? We cannot attempt an answer here, as it will involve going into questions of monetary theory, policy, and empirical testing (However, see Appendix G on this subject). It should suffice to say is that is state that the most common measure of money supply is that provided by M or M_1 .

Till 1978 the RBI also used to concentrate most of its accounting analysis on this narrow measure of money supply. But things have changed since. Due to the introduction of a change in 1978 in the division of savings deposits of banks as between demand deposits and time deposits the data on M for post 1978 years are no longer comparable with those for the previous years. So, the RBI has shifted its accounting analysis of changes in money supply in terms of M_1 .

But whatever the measure of money supply used, one thing clearly stands out about its time profile in India-that its rate of growth has accelerated over time. Thus, in the case M (narrow definition), the annual average rate of growth was 3.6% during the 1990s, 8.9% during the 2000s, and 13.9% during the 2008s. The corresponding rates of growth for M_1 (broad definition of money) were 6%, 9.2% and 16.9% (For annual on M_1 and m_1 since 2008-09).

At this state we do not have any basis to either explain the sources of increase in M (or mM_1) or AMR (or M_1) or to evaluate such increase as socially beneficial or injurious.

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CHAPTER



RESERVE BANK OF INDIA AND ITS ROLE

The Reserve Bank of India is the central bank of our country. The Reserve Bank of India established on 1st April 1935 under the Reserve Bank of India Act, which was passed in the year 1934. The Reserve Bank of India was started originally as a shareholders' bank and its paid up capital was Rs. 5 crores. When Reserve Bank of India was established, it took over the function of currency issue from the Government of India and the power of credit control from the then Imperial Bank of India.

The Reserve Bank of India was nationalised in the year 1948. The question which arises is why the Reserve Bank of India was nationalised in 1948 soon after independence. There are two/three major reasons, which account for the nationalization of the Reserve Bank of India in 1948.

Firstly, immediately after the end of Second World War there was a trend towards nationalization of central banks all over the world. The Bank of England was nationalised in 1946.

Secondly, in India there was inflation right from 1939 onwards and it was thought advisable to nationalize the Reserve Bank of India in order to control inflation in the country effectively.

Thirdly, as India had to embark upon a programme of economic development and growth, it was necessary to have a complete control over the activities of a central bank so that it could be used effectively as an instrument of economic change in the country.

Functions of the Reserve Bank of India :

The Reserve Bank of India performs all the important functions which are expected from a central bank, as such it performs the following major functions :

- (i) The Reserve Bank of India issues and regulates the issue of currency in India. In fact the Reserve Bank of India is sole authority for the issue of currency in the country. This power enables the Reserve Bank of India to regulate and control money supply in the country.
- (ii) The Reserve Bank of India acts as a banker to Government. The Reserve Bank of India acts as a banker not only to the Government of India but also as a banker to the State Governments. The Reserve Bank of India looks after the current financial transactions of the Government and manages the public debt of the Government. As a banker to the Government, the Reserve Bank of India has the obligation to transact the banking business of the Central Government. The Reserve Bank undertakes to accept money on account of the Government, to make payment on behalf of the Government. It also carries out exchange remittance and other banking appertains including the management of public debt.
- (iii) The Reserve Bank of India acts as a banker to the Commercial Banks, Just as the private individuals keep and maintain their accounts with Commercial Banks, Commercial Banks keep and maintain their accounts with the Reserve Bank of India. The commercial banks keep deposits with the Reserve Bank of India and they borrow, money from the Reserve Bank of India when necessary. In case of difficulties, the Reserve Bank of India acts as a lender of the last resort to commercial banks.

- (iv) The Reserve Bank of India exercises its control over the volume of credit created by the commercial banks in order to ensure price stability.
- (v) Reserve Bank of India has the responsibility to maintain not only the internal value of the currency, *i.e.*, the Indian Rupee, but it has also to maintain the external value of the currency. In short the Reserve Bank of India is largely concerned with organisation of a sound and healthy commercial banking system, ensuring effective co-ordination and control over credit through appropriate monetary and credit policies followed from time to time. However, in India the Reserve Bank of India is also concerned with development of rural banking, promotion of financial institutions and development of money and capital market in India.

Reserve Bank of India and Its Promotional Role :

Reserve Bank of India, as a central bank of our country, has to perform not merely the negative role of controlling credit and currency in the economy to maintain the internal and external value of the rupee to ensure price stability in the economy, but also to act as a promoter of financial institutions in the country so that its policies could be effective in promoting economic growth as per the guidelines and policies formulated by the Government. When the Reserve Bank of India was established in 1935, our country was a backward country which lacked a well-developed commercial banking system apart from the absence of a well-developed money market in the country. After 1948 the Reserve Bank of India became very active to take steps to promote and develop financial institutions so that the Reserve Bank of India can pursue appropriate credit and monetary policies for economic growth and development in an era of planned economic development of the country.

Reserve Bank of India has, therefore, taken the following steps as promotional measures :

- (1) Reserve Bank of India established the bill market scheme in 1952.

- (2) Reserve Bank of India has tried to help the establishments of financial corporations to provide credit to the agriculture sector of economy and also the industrial sector of the economy.
- (3) Reserve Bank of India has promoted regional rural banks with the help of commercial banks to extend banking facilities to rural areas.
- (4) Reserve Bank of India has taken steps to enable the commercial banks to open branches in foreign centers and has helped the establishment of an export-import bank in India to provide finance to exporters.
- (5) Reserve Bank of India encourages and promotes research in the areas of banking.

Organisation of the Reserve Bank of India :

The affairs of Reserve Bank of India are managed by the Central Board of Directors. The Central Board of Directors consists of following :

- (1) a Governor and not more than four Deputy Governors appointed by the Central Government under Section 8(1)(a) of the Reserve Bank of India Act, 1934,
- (2) four Directors nominated by the Central Government, one from each of the four Local Boards in terms of Section 8(1)(b),
- (3) ten Directors nominated by the Central Government under Section 8(1)(c), and
- (4) one Government official nominated by the Central Government under Section 8(1)(d).

Reserve Bank of India has a Local Board with Headquarters at Bombay, Calcutta, Madras and New Delhi, Local Boards consist of five members and these members are appointed by the Central Government to represent territorial and economic interest and the interest of co-operatives and indigenous banks.

Chairman of the Central Board of Directors of the Reserve Bank of India is called the Chief Executive Authority of the Bank and he is known as the Governor. The Governor has the powers of general

Superintendence and direction of the affairs and business of the bank and he is authorized to exercise all the powers, which may be exercised by the bank. In the absence of the Governor, the Deputy Governor nominated by him exercises his powers.

Reserve Bank of India and Commercial Banks :

The Commercial Banks maintain accounts with the Reserve Bank of India and borrow money when necessary from the Reserve Bank of India. The Reserve Bank of India thus provides credit to commercial banks and commercial banks in turn provide credit to their clients to promote economic growth and development. However, credit cannot be extended to an unlimited extent because it would disturb price stability in the country and therefore, it becomes necessary for the Reserve Bank of India to control the activities of the commercial banks in the interest of price stability. The Reserve Bank of India controls the activities of the commercial banks by virtue of the powers vested in it under the Banking Regulations Act of 1949 and the Reserve Bank of India Act, 1934.

The Banking Companies Act was passed in the year 1949 in order to remove the defects in the banking system and to strengthen the banking structure so that the banking system can be used as an instrument of economic change in the country. The Banking Regulation Act, 1949 also gives powers to the Reserve Bank of India to control and supervise the activities of the commercial banks in the country.

According to the Banking Regulation Act, 1949, the Reserve Bank of India is given a power to issue license to commercial banks to open branches. No commercial bank can commence the business of banking without obtaining license from the Reserve Bank of India. The Reserve Bank of India has also power to withdraw the license once granted in case it is found the affairs of the bank are not managed properly. The Reserve Bank of India has been given a power to inspect the commercial banks under Section 35 of the Banking Regulation Act. Under this power, the Reserve Bank can itself at any time cause an inspection to be carried out by one or more of its officers of any bank and its books and accounts and if there are defects, the banks concerned are required to rectify them

and the Reserve Bank of India has power to appoint Additional Directors on the Boards of Directors.

According to the Banking Regulation Act the Reserve Bank of India has wide powers of over-all control over the management of banks. Under this Act Section 35(b), the approval of the Reserve Bank of India is necessary for the appointment or reappointment or termination of an appointment of a Chairman, Managing or whole Time Director. The Reserve Bank of India has a power to prevent a commercial bank from undertaking certain types of transactions.

According to Section 21, the Reserve Bank of India has been given a power to control advances granted by the commercial banks. This power is known as the power of Selective Credit Control. Under this Section, the Reserve Bank of India is empowered to determine the policy in relation to advances to be followed by banks generally or by any bank in particular and under this Section, the Reserve Bank of India has been authorized to issue directions to banks as regards the purpose of the advances, the margins to be maintained in respect of the secured advances and it can also prescribe the rate of interest and other terms and conditions on which advances may be made.

Apart from the Selective Control of Credit exercised by the Reserve Bank of India, the Reserve Bank of India controls the volume of credit in a quantitative way so as to influence the total volume of bank credit. The Reserve Bank of India does this through the use of following instruments :

- (1) The Bank Rate
- (2) Open Market Operations
- (3) Variable Cash Reserve Requirements

(1) **The Bank Rate** : The Bank Rate is the rate of interest at which the Reserve Bank of India rediscounts the first class bills of exchange from commercial banks or other eligible paper. Whenever the Reserve Bank of India wants to reduce credit, the bank rate is raised and whenever the volume of bank credits is to be expanded the bank rate is reduced. This is because by change in the bank rate, the Reserve Bank of India seeks to influence the cost of bank credit.

In India the bank rate has been changed frequently from 1951 onwards and today the bank rate stands at 10%. However, the efficacy of the bank rate depends on the extent of integration in the money market and also it depends upon how far the commercial banks resort to borrowings from the Reserve Bank of India.

(2) *Open Market Operations* : Reserve Bank of India can influence the reserves of commercial banks, *i.e.*, the cash base of commercial banks by buying or selling Government Securities in open market. If the Reserve Bank of India buys Government Securities in the market from commercial banks, there is transfer of cash from the Reserve Bank of India to the commercial banks and this increases the cash base of the commercial banks enabling them to expand credit and conversely if the Reserve Bank of India sells Government Securities to the Commercial Banks, the commercial banks transfer cash to the Reserve Bank of India and therefore their cash base is reduced thus adversely affecting the capacity of commercial banks to expand credit. The success of open market operation as a technique of credit control depends upon of size of Government Securities available, their range in variety and the ability of the market to absorb them.

(3) *Variable Reserve Requirements* : The commercial banks are required to keep a certain percentage of deposits as reserves with the Reserve Bank of India. The Reserve Bank of India is legally authorized to raise or lower the minimum reserves that the bank must maintain against the total deposits. If the percentage of reserves to be maintained is increased, the commercial banks will be left with less cash and therefore, they have to contract credit and if this limit is reduced, the commercial banks will have more cash with them and they would be able to expand credit. The Reserve Bank of India has got the power to use the variable reserve requirements as an instrument of monetary control only in 1956 when the bank was authorized to vary the minimum cash reserve requirement to be maintained by commercial banks between 5% and 20% of demand deposits and 2% and 8% of time deposits.

In addition to this, the Reserve Bank of India was empowered to impound banks' reserves in excess of a certain level reached in a

phased period. The commercial banks are also required to maintain a Statutory Liquidity Ratio and to arrive at the statutory liquidity ratio, the following assets are taken into account :

- (1) Cash in hand in India.
- (2) Balance in the current accounts with the State Bank of India (SBI) and its subsidiaries in India.
- (3) Balances with the Reserve Bank in excess of the minimum reserve requirement at 7 per cent of total demand and time liabilities.
- (4) Investments in Government securities, treasury bills and other approved securities in India.

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borrowings from the Reserve Bank of India against approved securities and borrowings from State Bank of India and other notified banks. The remainder of the liquid assets expressed as a percentage of the total demand and time liabilities is the statutory liquidity ratio.

Therefore, Reserve Bank of India has been empowered to control the volume of credit quantitatively through the use of bank rate, open market operations and variable reserve requirements apart from impounding of deposits beyond a certain level and the Reserve Bank can influence the volume of credit in certain selected areas through the use of selective credit control by prescribing the margins to be maintained in respect of secured advances against commodities, rate of interest on advances and by regulating the purpose or purposes for which advances may or may not be granted by the banking system as a whole or by group of banks or by a single bank as the case may be.

Board for Financial Supervision :

The Narasimham Committee recommended that the supervisory function be separated from the more traditional central banking functions of the Reserve Bank and that a separate agency which could be a quasi-autonomous Banking Supervisory Board under the *algis* of the Reserve Bank be setup. The Committee also

proposed that the Board should have supervisory jurisdiction not merely over the banking system but also over the development finance institutions, non-banking financial intermediaries and other para banking financial institutions such as those which accept deposits or float bonds from the public.

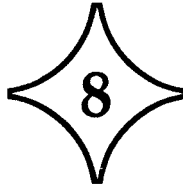
The Government, has approved the Statutory regulation under the provisions of Section 58 of the Reserve Bank of India Act, 1934 in connection with the setting up of the Board for Financial supervision and notification has been issued to this effect on 28.7.1994. A new Department of Supervision (DOS) was set-up on 22.12.1993 to give operational support to BFS. The Board will undertake supervisory of commercial banks and in due course its supervising functions would be extended to financial institutions and non-banking financial companies as well. The department of supervision has been set-up with its Central Office at Bombay and 16 Regional Offices at various Centers.

The DOS is presently designing an appropriate reporting system to enable it to exercise off-site surveillance over commercial banks. Special investigations including those connected with compliance and frauds and the work relating to appointment of statutory auditors for 27 public sector banks and 7 public financial institutions and the Reserve Bank are being attended to by the new department.

According to Section 35A of Banking Regulation Act, 1949 the Reserve Bank may issue directions to Banking companies who are bound to comply with such directions.

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CHAPTER



E-BANKING AND INNOVATIVE BANKING

In the present era of revolution in information technology, the economic setup of every country has witnessed tremendous changes in their day to day business. The banking sector too has not remained untouched and unaffected by these changes. It has introduced many new processes, as E-Banking and innovated its day-to-day working.

To day's banking is Virtual or Innovative Banking which denotes the provision of banking and other related services through the extensive use of Information Technology (IT), without direct resource to the bank by customers. The salient features of Innovative Banking are overwhelming reliance on IT and the absence of physical bank branches to deliver banking services to the customers

Meaning of Innovative Banking :

The term 'Innovative' means to introduce a new process. The introduction of computer devices like electronic Data, Interchange, E-mail, Electronic Bulletin Board *etc.* has transformed the whole working of the present system. With the introduction of these new changes, the procedures and methods of banking business has undergone a revolutionary change. Thus, Innovative Banking refers

to the incorporation of new ideas, strategies, methodologies and procedures in their day-to-day functioning. In other words, Innovative Banking is a banking process where the operation and management of business activities are conducted with new procedures and methods keeping in view the convenience of the customers in general and earning of profits by the banking institution in particular.

Meaning of E-Banking

E - Banking refers to performing basic banking transactions by customers round the clock globally through Electronic Media. In other words, E-banking is the application of IT infrastructure with latest equipment and solutions and integrated networks essentially to facilitate smooth and efficient payment and settlement, improved customer service and the resultant increase in profitability.

Modern banking is more information based, speedy and boundary less due to the impact of Electronic Revolution. Modern banks have to be well versed in Information Technology - its uses and applications. Banking divisions have to be IT based, with the spread of digital technology. E banking is more of a science than an art. E banking is knowledge based and mostly scientific in using electronic devices of the computer revolution. When most business and commerce organisation tend to become internet working organizations, banking has to be E-banking in the new century.

Difference between Traditional Banking and E-Banking :

Following are the main differences between these two types of banking:

Traditional Banking :

1. In traditional banking, the customer has to visit the branch of the bank in person to perform the basic banking operations *viz.*, account inquiry, funds transfer, cash withdrawals *etc.*
2. The brick and mortar structure of a bank is essential to perform the banking functions.
3. These are confined to branches with less delivery channels.

4. Banking transactions are conducted only in the banking hours and that too in the same building.
5. Traditional banking is an art.

E-Banking :

1. E-Banking enables the customers to perform the basic banking transactions by sitting at their office or at home through PC or LAPTOP. The customers having an access to the banks website for viewing their accounts details and perform the transactions on account as per their requirements.
2. With E-Banking, the brick and mortar structure of traditional banking gets converted into a click and portal model thereby giving a concept of virtual or innovative banking a real shape.
3. E-banking is no longer confined to branches. Customers are being provided with additional delivery channels which are more convenient to the customers and are cost effective to the banks. These delivery channels include ATM, Tele Banking, Internet Banking, Mobile Banking, Home Banking etc.
4. E-Banking facilitates banking transactions by the customers round the clock globally.
5. E-banking is more of a science than art, E-banking is knowledge based and mostly scientific in using the electronic devices of the computer revolution when most corporates tend to become internet working organizations, banking has to be E-banking in the new century.

Important Aspects of E-Banking :

E-banking means the conduct of banking operations electronically. It calls for elimination of paper-based transactions and radical change in the banking operations. E-banking will operate through internet, extant and intranet. E banking is, therefore, a banking on the information super high ways on the frontier of the internet. E-banking must have the following dimensions.

(i) **Easy Access to Customers** : E-Banking is basically Internet based. Banking products and services such as deposits, remittances, credit cards *etc.* as well as all important banking information's can be made available with easy access to customers on internet. Thus, E-banking is a customer-to-bank service. Customers can make use of these services with no restricted office hours, no queues, no tellers and no waiting. Several Network innovations for E-banking can be visualized such as smart card, Electronic Data, Interchange *etc.* Of course, the banking operations have to be guarded against unauthorised access by intruders.

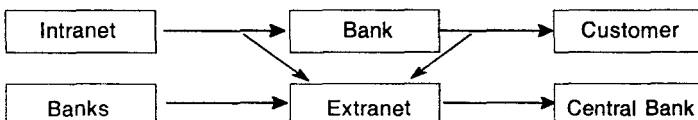
(ii) **Inter-bank Transactions** : This form of electronic banking is for transacting inter-bank transactions such as money-at-call *etc.* In other words, it is a bank-to-bank service. This type of E-banking is driving extents, which is restricted to banks only. Hence, it is well secured and unauthorised access is less.

(iii) **Electronic Central Banking** : Under electronic central banking, all banks, within the purview of a central bank, are interconnected on extranet to facilitate clearing of cheques, management of cash reserves, open market operations, discounting of bills *etc.* In fact, the Central Bank has to be connected with the government treasury on extranet to carry out its functions as an agent of the government. Again, the central banks of all the countries can be inter-linked with I.M.F., World Bank and other international financial institutions through extranets.

(iv) **Intranet Procurement** : For the transactions that are internal to a bank, between the banks and its branches and subsidiaries, Intranet procurements of banking is needed. On the other hand, Extranet permits a bank to have full control over the users of intranet and the information to *be* transmitted.

The Extranet-Intranet-Internet relationship that exists in the process of E-banking has been shown in the following figure:

Chart showing Micro Model of E-Banking



Extensive work is needed to integrate internal and external communication of bank-related information through banking internet and intranet for the development of the financial sector.

Importance of E-Banking :

E-banking has the following important advantages:

(1) **Convenient Banking** : E-banking increases the customer's convenience. No personal visit to the branch is required. Customers can perform basic banking transactions by simply sitting at their office or at home through PC or LEPTOP. Customers can get drafts at their doorsteps through e-mail call. Thus, E-banking facilitates home banking.

(2) **Quality Banking** : E-banking opens new avenues for providing efficient, economic and quality service to the customers. It allows the possibility of improved quality and an enlarged range of services being made available to customers.

(3) **Round the Clock Banking** : E-banking facilitates performing of basic banking transactions by customers round the clock globally. Worldwide 24 hours and 7 days a week banking services are made possible. In fact, there are no restricted office hours for E-banking.

(4) **Service Banking** : E-banking creates strong basic infrastructure for the banks to embark upon many cash management products and to venture in the new fields like E-commerce, FDI etc. Instant credit, one-day credit, immediate payment of utility bills, instant transfer of funds etc. would be made possible under E-banking. In short, it adds conveniences to the entire banking services apart from widening the range of services.

(5) **Low Cost Banking (Service)** : With the coming into existence of E-banking, the operational costs have come down due to technology adoption. The cost of transactions through internet banking is much less than any other traditional mode.

(6) **Low Cost Banking (Establishment)** : Brick and mortar structure of banking gets converted into click and Portal banking. Banks can have access to a greater number of potential customers without the commitment costs of physically opening branches. Thus,

there is much saving on the cost of infrastructure. Moreover, requirements of staff at the banks get reduced to a greater extent.

(7) **Speed Banking**: The increased speed of response to customer requirements under E-banking will lead to a greater customer satisfaction and handling a larger number of transactions at a lesser time. Thus, it increases the customers' convenience to a greater extent and facilitates better customer retention.

(8) **Profitable Banking**: The increased speed of response to customer requirements under E-banking vis-a-vis branch banking can increase satisfaction and, consequently can lead to higher profits via handling a large number of customer accounts. Banks can also offer many cash management products for the existing customers without any additional cost.

From the above it is clear that E-banking has showered many benefits to the customers, banking system and others.

Impediments of E-Banking :

Although E-banking has many advantages, however, the following factors contribute as major constraints in the smooth implementation of E-banking.

(1) **Initial Cost** : Many banks have expressed their concern about the huge initial start-up cost for entering into E-banking. The start-up cost includes the following: (i) The connection cost to the internet or any other mode of electronic communication. The network should be robust, secured, efficient and scalable with in built redundancy; (ii) The cost of sophisticated hardware, software and other related components including Modem, Routers, Bridges, Network Management system *etc.*; (iii) The cost of maintenance of all equipment's, websites, skill level of employees *etc.*; (iv) The cost of setting up organisational activities to implement E-banking.

For a successful E-banking, bankers need to develop a coherent perspective of the role of network technologies and advancement of their EFT-departments with a competitive introspection of their banking business.

(2) **Training and Retention of Staff** : The introduction of E-banking involves 24 hours support environment, quality service to

end-users and other partners which would necessitate a well-qualified and robust group of skilled persons to meet external and internal commitments. Hence, the bank has to spend a huge amount on their training. In this connection, what is more important is their retention in the organisation after imparting necessary training. Moreover, the bank has to outsource certain functions and services to maintain the level of standards and state of readiness. The training and retaining of skilled manpower is a major source of concern.

(3) Shortage of Skilled Personnel : It is a well-known fact that there is scarcity of web developers, content providers and knowledgeable professionals to route banking transactions through internet. In a fast changing technological scenario, the obsolescence of technology is fast and hence there is always a paucity of skilled personnel.

(4) Restricted Business : All the transactions cannot be carried out electronically. Many deposits and some withdrawals need the use of postal services. Some banks have automated their front-end process for the customers, but still largely depend upon manual processes at the back-end. For example, the Internet customers receive their statements online, but paper statements are also sent by mail. Mail and distribution costs are still necessary as the statements, cheques *etc.* are still mailed.

(5) Restricted Clientele and Technical Problems : The user of E-banking needs a computer and time to log on the site. It means that target clientele is restricted to those who have a home PC or can access the 'Net' through the office or cybercafes. Moreover, phone connections are not always perfect and, on a home PC, the modern connection often breaks off, requiring another tedious log-on. Navigating around websites on home computers is often slow and frustrating. Moreover, local calls are not free generally and so the customer has to pay every time he checks his balance.

(6) Legal Issues : Legal framework for recognising the validity of banking transactions conducted through 'Net' is still being put in place. Although initial legal framework has been devised for E-banking activities, it is uncertain as to what legal issues may prop

up in future as banking on internet progresses. What may happen if a customer's sensitive data falls into the hands of a stranger or if his account shows a 'Nil' balance all of a sudden without his knowledge? The legal issues should cover unauthorised access, and an unauthorised modification of data, wrongful communication, and punishment to be meted out to combat computer crimes. To prevent computer crimes, the country's banking legislation needs to make suitable provisions with a thorough consultation and discussion among the legal as well as technical experts.

(7) *Appropriate Security* : Many problems of security are involved in paper less banking transactions. A security threat is defined as a circumstansive decision or event with potential to cause economic hardship to data or network resources in the form of destruction, disclosure, modification of data, denial of services, fraud, waste and abuse. There are chances that documents such as cheque, pass book *etc.* can be modified without leaving any visible trace. Distortions of information's are also possible. Providing appropriate security may require a major initial investment in the form of application encryption techniques, implementation of firewalls *etc.* In spite of implementation of several security measures, the possibility of a security breach cannot be ruled out.

(8) *Destruction of Pricing Mechanism* : It may be possible that the Internet may destroy the basic business pricing models. The internet creates perfect market conditions where prospective consumers have access to more information and can more readily compare rates and financial products offerings. Now, players in the field have lower costs than old banks. Hence, they can undercut the prices and provide stiff competition to established banks.

Moreover, banks marketing programmes and products are generally based on product or physical location. The web allows customers to easily compare all the products and their prices and sign-up for the products irrespective of location.

From the above, it is clear that there are many hurdles in the successful functioning of E-banking, particularly the start-up cost, expenses on the training of personnel, legal issues *etc.*

Corrective Measures :

Most of the problems given above are in the nature of teething problems and hence the same can be eliminated over a period of time. However, for venturing into E-banking, the following controls and corrective measures must be ensured:

(1) **Authenticity Controls** : These are required to verify identity to individuals like password, PIN *etc.*

(2) **Accuracy Controls** : These are needed to ensure the correctness of the data flowing across the network.

(3) **Completeness Controls** : These controls are required to make sure that no data is missing.

(4) **Redundancy Controls** : These controls are essential to see that data is travelled and proceeded only once and there is no repetitive sending of data.

(5) **Privacy Controls** : These are needed to protect the data from inadvertent or Unauthorised access.'

(6) **Existence Controls** : These controls are required to make sure that on going availability of all the system resources will be the same throughout.

(7) **Audit Trail Controls** : These are needed to ensure keeping chronological role of events that are occurred in the system.

(8) **Efficient Controls** : It is also desirable to ensure that the system uses minimum resources to achieve desired goal *i.e.* increase in efficiency.

(9) **Fire Wall Controls** : These controls are essential to prevent unauthorised users accessing the private network, which are connected to Internet.

(10) **Encryption Controls** : These controls are needed to enable those who possess secret key to decrypt the cyber text.

Virtual Banking

The practice of banking has undergone a significant transformation in the nineties. While banks are striving to strengthen customer relationship and move towards 'relationship banking',

customers are increasingly moving away from the confines of traditional branch banking and are seeking the convenience of remote electronic banking services. And even within the broad spectrum of electronic banking, the aspect of banking that has gained currency is virtual banking. Thus, in the present set up it is 'actual banking' and is inseparable part of innovative banking.

Meaning :

Broadly speaking, Virtual banking denotes to the provision of banking and related services through extensive use of information technology without direct recourse to the bank by the customer.

The origin of virtual banking in the developed countries can be traced back to the seventies with the installation of Automated Teller Machines (ATMs). Subsequently, driven by the competitive market environment as well as various technological and customer pressures, other type of virtual banking services have grown in prominence throughout the world.

Types :

The important types of virtual banking include Automated Teller Machines (ATMs), Shared ATM networks, Electronic Funds Transfer of Sale (EFToS), Smart Cards, Stored-Value Cards, Phone-banking and more recently internet and intranet banking. The salient features of these services are the overwhelming reliance on information technology and absence of physical bank branches to deliver these services to the customers.

Phases of Virtual Banking :

Three evolutionary phases of virtual banking services, which represent the impact that the particular application has achieved within the industry, include the following:

(i) *Inception Phase* : Here the technology behind the application is in its infancy and a substantial amount of investment is required so as to make the application widely available commercially.

(ii) *Growth Phase* : Here the application is increasingly available to the customers and the technology behind the application is widely available.

(iii) Maturity Phase : Here the application is in widespread use and institutions not offering such applications are likely to be at a competitive disadvantage.

Benefits of Virtual Banking :

The financial benefits of virtual banking services are many types and have been discussed below:

(i) Lower Cost : Virtual banking has the advantage of having a lower cost of handling a transaction via the virtual resource compared to the cost of handling the transaction via the branch.

(ii) Enhance Customer Satisfaction : The increased speed of response to customer requirements under virtual banking *vis-a-vis* branch banking can enhance customer satisfaction and, *ceteris paribus*, can lead to higher profits via handling a large number of customer accounts. It also implies the possibility of access to a greater number of potential customers for the bank without the concomitant costs of physically opening branches.

(iii) Cost Efficiency : The lower cost of operating branch network along with reduced staff costs leads to cost efficiency under virtual banking.

(iv) Improved Quality : Virtual banking allows the possibility of improved quality and an enlarged range of services being available to the customer more rapidly and accurately and at his convenience.

Caution : On the flip side of the coin, however, it needs to be recognised that such high cost technological initiatives need to be undertaken *only after* the viability and feasibility of the technology and its associated applications have been thoroughly examined. It is not the inherent sophistication of technology, but the usefulness it offers to customers and, by extension, the commercial advantage it provides to institutions that needs to be kept in mind before going ahead with such technological practices.

Innovative Banking (E-Banking and Virtual Banking)

Early Background :

In our country till the 'eighties', the banks were operating in a protective environment characterised by administered interest rates,

high level of pre-emptions in the form of reserve requirements and directed credit. Banking sector reforms were ignited in 1992 against the backdrop challenges faced by Indian banks from within and outside the banking system in the country as well as forces of globalizations operating worldwide. The accent to the reform process was to improve productivity and efficiency of the financial system.

Keeping in view this reform process the introduction of Innovative Banking was initiated.

Induction of information technology and communications networking system was set to change the operating environment of the banks drastically. Technology has already enabled some of the banks to introduce innovative products to their customers in the form of ATM facility, tele banking, home banking, 'any time' and 'anywhere' banking etc. While introducing innovative banking the following efficiency motives have been considered.

(i) Organisational Structure : With a view to reaping full benefits of liberalization, the organisational structure of the banks need to be studied carefully. In this context, the chain of command needs to be shortened with adequate authority delegated to the branches. This would also help to enhance efficiency.

(ii) Adoption of Proper Internal Systems : In addition to the organisational structure, adoption of proper internal systems and methods can greatly help in efficient functioning of the banks.

(iii) Human Resource Development : Another issue that assumes importance in improving the efficiency of the banks is the human resource development. Recruiting the right people, training/retraining them on a continuous basis, keeping in view the changing government and increasing complexities and having a remuneration/incentive structure conducive to keeping their moral high, are considered integral part of the process.

(iv) Consumer Service : Another significant factor/motive determining the efficiency and competitiveness is the customer service. The realisation that customer service satisfaction is essential for survival and growth has dawned on all the banks. The banks

that will emerge as the winners in the impending era will be truly customer-centric banks.

Progress: With reference to the above context it may be noted that Virtual Banking has made some beginning in the Indian banking system, (i) ATMs have been installed by almost all the major banks in major metropolitan cities, (ii) The shared payment Network system (SPNS) has already been installed in Mumbai and (iii) Electronic Funds Transfer (EFT) mechanism by major banks has also been ignited. (iv) The operationalization of the Very Small Aperture Terminal (VSAT) is expected to provide a significant thrust to the development of Indian Financial NET Work (INFINET) which will further facilitate connectivity within the financial sector.

The popularity which virtual banking services have won among customers, owing to the speed, convenience and round-the-clock access they offer, is likely to increase in the future. However, several issues of concern would need to be pro-actively attended. While most of electronic banking has been built-in security features such as encryption, prescriptions of maximum monetary limits and authorizations, the system operators have to be extremely vigilant and provide clear-cut guidelines for operations. On the larger issue of electronically initiated funds transfer, issues like authentication of payments instructions, the responsibility of the customer for secrecy of the security procedure would also need to be addressed.

Important Recommendation of Vasudevan Committee on Technology Upgradation in the Banking Sector (1999)

The following are its important recommendations:

(1) **Usage of INFINET (Indian Financial Network)** : For both inter-bank and Intra-bank applications, it is necessary to have an application architecture keeping in mind that INFINET backbone network will be VSAT based.

(2) **Standardization and Security** :

(a) There should be an appropriate institutional arrangement for key management and authentication by way of certification agency. RBI may consider

appointing IDRBT (Institute for Development and Research in Banking Technology) as the certification agency for security management.

- (b) Banks should adopt widely used standard of cryptography procedures to prevent data temper during transmission.
- (c) The technology should be allowed to evolve into standard-based solutions for MultiFinder heterogeneous environment working co-operatively and collectively for EFTPOS, including the debit, credit and smart cards based operations.

(3) *Computerization of Government Transactions:*

- (a) There is a need to computerise all branches of banks dealing with Government transactions.
- (b) The computerization of government departments should be synchronized with computerization of bank branches dealing with Government transactions.

(4) *Legal Framework for Electronic Banking :*

- (a) Reserve Bank may promote amendment to the RBI Act, 1934 and assume the regulatory and supervisory powers on payment and settlement systems. Simultaneously, the RBI may promote a new legislation on Electronic Funds Transfer System (EFTS) to facilitate multiple payment system, to set up for banks and financial institutions.
- (b) RBI and IBA (Indian Banks Association) should peruse with the Department of Telecommunications (DoT)/ other competent Authority to per encryption of data files/messages transmitted through communication channels for facilitating easier access to remotely located branches to the INFINET (Indian Financial Network) network.

(5) *Other Related Issues :*

- (i) *Re-engineering* : Banks may choose the branches and areas of operations where they have already introduced

a certain degree of automation and computerisation and review the systems and procedures in these branches/areas to adapt them to the technology that is newly introduced.

- (ii) The newly established private banks which have the advantage of starting with the latest technology from the very beginning, should take up the process re-engineering in the right earnest.
- (iii) Each bank should chalk out a time-bound programme, synchronising with the level of computerisation being planned by it, stemming from the directions of the top management.

(6) *Issues Relating to Human Resource Development :* Education of staff on IT should be given due importance. The training establishments of the banks should be strengthened with adequate personnel and other infrastructure facilities, to import necessary IT training to all levels of staff.

(7) *Sharing of Experiences on Technology Implementation :* The meetings CPPD (Computer Policy and Planning Department) chiefs should be sufficiently frequent enough to be effective. Meeting by the IBA for this purpose, once in two months would be useful.

Important Facilities provided by E-Banking / Innovative Banking

(1) *Computerisation :* Now-a-days almost all banks have computerised their operations. Besides, all banks in different countries are inter-linked with each other through internet. This mechanism has facilitated easy remittance of money not only inside the country but also to any part of the world through the press of button. Money can be transferred from one account in one branch to another account in another branch of the same bank or a different bank.

After the introduction of computers, M.T. (Mail Transfer) and T.T. (Telegraphic Transfer) have lost their significance. It is so because computers have facilitated speedy remittance of funds from

one end to another in a moments notice. Thus, it minimizes the loss of interest since money is transferred instantly from one end to another. Moreover, it facilitates transfer of money from one branch of a bank to another branch of a different bank also which is not possible in the case of M.T. or T.T.

Recently arrangements have been made to pass on messages either general or specific through Satellite facility. For instance banks all over the world are inter-linked with satellite maintained by SWIFT (Society for Worldwide Inter-bank Financial Telecommunications) in Europe. In India, Gateway, Bombay, maintained by the computer Maintenance Corporation of India is its agent. Those banks which want to enjoy this satellite facility in India can open SWIFT centers with Gateway, and thus, all the banks in the world are inter-linked with each other. Any general information like foreign exchange rate movements or specific information like remittance of money, or opening of Letter of Credit or making forfeiting arrangements can be passed on to the banks concerned or to all the banks as a whole as the case may be in a moment's notice through this satellite arrangement.

Banks have also introduced mechanised cheque clearance using magnetic ink character recognition (MICR) technology. Banks are also in the process of setting up exclusive data communication network for banks known as BANK-NET. Banks are now switching to Personal Computers (PCs) and LAN/VAN systems. The Reserve Bank has put-in place Electronic Funds Transfer (EFT) system, Delivery Vs. Payment (DVP), Electronic Clearing Services (ECS) and RBINET. It has also taken steps to set up a Very Small Aperture Terminal (VSAT) Network which will cover all banks and financial institutions to serve as a number of tasks like MIS, data warehousing, transaction processing, currency chest accounting, ATMs, EFT, EDT, Smart / Credit cards, etc.. It will cover 2,800 centers soon.

(2) **ATM Facility** : The introduction of Automated Teller Machines facility is an important step in the banking sector. The leading banks of the country have established ATMs, not only in their head offices but also at the branches, to provide twenty four services to their customers so that they may be able to have

transactions in money. The customer, who possess the ATM card, can go to the ATM branch of the bank and can draw any amount from his deposited money. He can also deposit any amount in the bank with the help of ATMs.

(3) **All Day Banking** : Some banks provided the facility of all day banking. Under this scheme the bank remains open for transactions on all the seven day, including Sundays and Government holidays. The customers take full advantage of these facilities.

(4) **Anywhere Banking** : This is another facility provided by the banks. Under this provision, the bank customers have the option to have transaction at any branch or place, including branches outside the country. Thus, a person anywhere in the country or in a foreign country can withdraw or deposit his/her money with the branch of the bank, where he has account.

(5) **Net Banking or 'On Line Banking'** : In the field of information technology, the internet has brought a tremendous revolution all over" the world. The banking sector has also not remained untouched by it. The internet has helped the banking sector to provide its services very rapid and fast. This new or changed form of providing this fast service is known as Net Banking or 'On Line Banking'.

In Net Banking, the customer is not required to go to any counter of the bank. He has simply to open his Personal Computer (PC) will click the website of the bank, put down his account card there, do the entry of some of his transactions (deposits and withdrawals) and will do O.K. by pressing enter. Further the bank will do the needful job. Thus, the concerned customer, in this way, will be able to finish his job in minutes rather than in hours and will be able to save his labour and cost.

The Net Banking is not only fast but also cheaper. A study in U.S.A. reveals that the cost of operation of the account in Net Banking one-fifth of a dollar. Further the Net Banking has also broken the geographical boundaries. You can now operate your account anywhere in the world and can transfer your money within no time. Money deposited in a foreign bank in any foreign country

can be collected in any city in India through internet or on Line Banking'. Thus, the future of Net Banking' is very bright in an underdeveloped country like India.

Net Banking is very popular in European countries and U.S.A., where it started functioning about 15 years back. But in India its origin is recent and it is considered to be the gift of millennium. The banks who have started network are ICICI Bank, Global Tourist Bank, IDBI, and some other banks. The public sector banks are also preparing themselves to come in this field. So far State Bank of India, Canara Bank,

Union Bank, *etc.* have initiated their functioning in this direction. Besides the Indian branches of foreign banks have also providing this facility.

(6) Mobile Banking or M-Banking : Mobile Banking or M-banking refers to that of banking system where a person, sitting miles away, can enquire and check his saving account and can do transactions with the help of his mobile phone. The beginning of M-banking is a significant step from the side of Innovative Banking.

Here it may be noted that a beginning has been made for converting internet portals into mortals for this technological change. The internet service givers, Cellular Operators, Telecommunication companies, E-Commerce Enablers, Mobile Phone Manufacturers and Net Working Companies have engaged themselves to shape their basic structure into wireless form. HDFC, IDBI and ICICI have already given a wireless to their infrastructure.

Operational Process of Mobile Banking : In M-banking the customer sends his message to the bank, through his cell-phone by using short-cut Messaging Service (SMS) technology. Within 12 to 18 seconds the answer of the message is received on the screen of the cell-phone. This service is available both for the credit card holders and bank account. The services included in it are present balance in the customer's account, order for the stoppage of payment on a cheque and the changes in the credit limit of the account. The customer has only to type the standard keywords on his cell-phone such as 'I' for IDBI bank, 'CCHQ' for cheque book, 'BAL' for balance. Suppose your Bank is IDBI, then for knowing your balance, you

have to type 'IBAL' in your cell-phone. Thus, this type of facility is available to a customer during his travel, or without coming over to the bank he comes to know the details of his financial position.

The speedy growth of M-banking is the need of the time. More hopes are also centralized on mobile phones, because mobile phone holders are more in number in the country as compared to Personal Computer (PC) and LOPTOP holders. The other merit of mobile phone is that one can carry it along with him/her, whereas the PC and LOPTOP cannot be carried anywhere and everywhere.

A question mark which is attached to both the Mobile banking or Online banking is the problem or question of security *i.e.* the fear of hacking and tampering of data. Secrecy is the essence of banking transactions. The security products both hardware based on application software based, should address the twin issues of taking care of customers interests and also ensure secure funds transfer.

(7) Wireless Application Protocol (WAP) : Cellular phone operators are forwarding towards the new technology of wireless Application Protocol. This is an important step towards converting information-based service to transaction based service. Thus, WAP is a technique, which helps banking transaction with the help of mobile phone. WAP is such a standard which makes it possible for internet access through WAP-enabled instruments and mobile phone, Palm Top, Personal Digital Assistant, Digital Diary *etc.* SMS is similar to that of E-mail whereas WAP provides internet on mobile phone. Although SMS is considered to be cheap and slow-speed service yet WAP is more favourable to customers, because it makes the real transaction possible and graphics can be downloaded by it. In this context ICICI has already started an other interesting banking service known as 'Bill junction Com' and the ICICI bank claims it is a first Online Bill presentation and payment service.

The WAP website provides all the account holders of the banks the facility to present their respective electricity, water and telephone bills on the internet and also provides the service of payment through their bank accounts.

Critics are of the opinion that Online Banking or Net-Banking has the chance of more success as compared to WAP banking. In

support of their opinion they argue that M-banking will consume more time of the consumers and also not more comfortable to the customers because the screen size of the mobile phone can not be enhanced.

(8) **Credit Cards** : Banks have recently introduced the credit card system. Credit cards are issued to good customers having a certain minimum income and having current or saving accounts, free of charge. The credit card enables a customer to purchase goods or services from certain retail and service establishments up to certain limit without making immediate payment. The establishments get paid by the bank operating the plan. The bank assumes the risk and responsibility of collecting the dues from the customers. Here it may be mentioned that the cardholder is required to pay neither an interest to the bank nor a higher price for goods purchased; he pays only a fee to the bank for the facility. Thus, through credit cards the banks have found the way of deploying the surplus/unused funds; thereby they have started gaining by interest, service charges *etc.*

The cost of arrangement is met from the increased sales which result from the use of the credit cards. In card issuing_ bank pays to the seller as soon as goods are sold but charges the buyer after 30 to 45 days. The bank also bears the risk that the card holder might default. For all this, the bank gets commission from the seller which is about 2.5 to 5 percent of the value of goods sold. The gain of the bank is the extent of commission from the seller minus the risk and interest factors, and administrative and advertising expenses. In addition the banks earn by way of initial, annual, add-on and re-issue fees from the prospective card holders. There are significant differences in the fees charged by different banks. The cards are usually used by elite corporate executives, businessmen, persons belonging to middle income groups and so on. They are usually used to buy consumer durables and certain services at establishments such as shops, hospitals, nursing homes, departmental stores, hotels, railways, petrol stations and so on.

Operational Procedure of Credit Cards: Each credit card bears the specimen signature of the holder and is embossed by the issuing

banker with the holder's name and address. The establishments, on presentation of the card, delivers the goods or provides the services. The supplier pieces the card in a special imprinter machine to record the holder's name and number on a sales voucher to which are added the particulars of the transaction. The holders sign the voucher and the signature is compared by the supplier with that on the card. The voucher is then sent to the bank which pays it after deducting its service charges. Once in a month, the bank sends a statement of all the credit purchase in the previous month to the credit holder and the latter has to remit the amount either by cash or by cheque.

Credit Through Credit Cards : The competition in the banking industry in marketing cards provides ample opportunity to consumers in making use of credit/debit cards. The opportunity created by this chance contributes to consumers making credit card choices without giving much weightage to the high probability that they will pay interest on their outstanding balances. Consumers pay a little or no attention to the risk involved with credit cards for the sake of ease of use and hope that they will have the time and ultimately the money to pay off their cumulated credit.

Although credit cards are available with interest rates ranging from 9 percent to 15 percent, most of the consumers use credit cards with interest rates as high as 18 percent or more. Another important factor that consumers don't consider much is that the annual fees/service charges vary from bank to bank. These factors could make a significant difference to the use of the credit cards by consumers. In addition, some customers are ignorant about how to transfer balances from cards with higher rates to cards with lower rates. Consequently, major credit card issuers are persistently earning from three to five times the ordinary rate of return in banking.

Credit Cards Create Credit : Though credit cards replace the use of cash and provide overdraft facility and additional borrowing power, the cardholders can make use of such facilities only if they agree to pay interest and other charges. The spending power of the cardholder depends on the drawing capacity. Credit cards are the key to the opening of bank account for daily payment by the

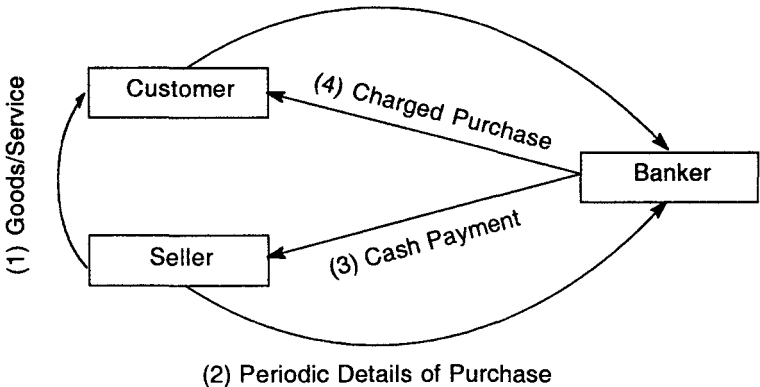
cardholder. Overdraft facility is also available in the range of Rs. 2000 to Rs. 10,000 or more, depending upon the credit worthiness of the cardholder.

The accompanying figure exhibits clearly how the credit is created through credit cards. Through credit card the issuing banks,

- (i) increase/create the credit,
- (ii) increase the reputation of the bank,
- (iii) increase the interest income and, in turn, total return to funds,
- (iv) increase the revenue/gain through incentive/commission which is usually given the business establishments that accept credit cards.

The banks create credit through credit cards but not through debit cards.

(5) Seller of Cash, Interest, Service Charges



Advantages:

- (i) The credit card is a convenient medium of exchange which enables its holder to minimize the use of hard cash in some of his transactions. The day is not far off when credit cards will totally eliminate the need for carrying cash.
- (ii) It extends to him a charge on flourishing a signature.

- (iii) It is a document of his credit worthiness, enabling him to obtain credit at designated establishments.
- (iv) The carding-issuing bank gets commission from the seller for the value of the goods sold. The gain of the bank is the extent of commission from the seller minus risk and interest factors and administrative and advertising expenses.
- (v) The banks also earn income by way of fees charged for the initial, annual and reissue of cards from the prospective cardholders.
- (vi) The acceptance of credit card enhances the business prospects of the businessman, because he is sure that he will get the payment for the goods sold in due course of time.
- (vii) The credit cards increases the image and popularity of the card-issuing bank. It gives rise to new customers and consumer credit and there is an enhancement in its savings or deposits in the current accounts.
- (viii) Credit cards also help in earning foreign exchange.

Limitations :

Sometimes the cardholders take undue advantage of the card. He buys excessive goods and delays in depositing the excess amount in the bank. If credit card is lost and goes into the wrong hands, the new holder takes the undue advantage. Although the customer informs the loss of the card to his bank but blurring the gap interval, however of short duration, the holder of the lost cards takes full benefit of it. Further the issuing banks have to bear some risk similar to unsecured debt. They may have the problem of non-payment or delayed payment of overdraft amount. Then if the card holder goes bankrupt, there is no legal validity to the payments already made through the credit card. The question here is that who will bear the liability for transactions in the pipeline. Definitely it will be the bank.

Future Prospects :

The facilities provided to credit card holders are fast expanding and its future prospects are bright in India. Central Bank and

Canara Bank permit their credit card holders to withdraw cash from any branch of the bank up to a certain limit. Central Bank got tied up with Master Card of U.S.A., the largest card-issuing organisation in the world. More than three million establishments, spread over 140 countries, honour MasterCard. As on June 1998, twelve banks, SBI and its associates were engaged in credit card business, further 20 Indian Banks have entered into business by having tie up arrangements with other banks.

The commercial banks in India started issuing credit cards in the beginning of 1980. The Credit Card business now has covered about 68,000 establishments, in the country, and accounted for a turnover of Rs. 3,000 crore in 1998. The latest generation cards available in India at present include ATM cards, change cards, phone cards, switch card, mercard, Pre-paid Mobile SIM cards, and smart cards. The next development about to take place in this line of business is the introduction of Electronic 'Smart -Point'.

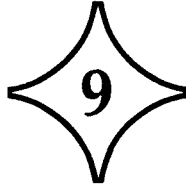
(9) **SMART Credit Card**: A smart card has an integrated circuit with a micro processor chip embedded in it which gives it enormous versatility. It could perform calculations, maintain records, act as an electronic purse storing electronic money. It is as e-money that smart card is most used and can be used in different areas of consumption of goods and services- with limits set against each of the defined areas. It is essentially a chip or memory card.

A pilot project on SMART Card technology in India titled 'SMART Rupees System (SMARS) was undertaken by the Indian Institute of Technology, Mumbai to examine the viability and use of SMART Cards as retail payment instrument within the country. It came out with a set of recommendations on SMART Card Standards and the same have been accepted by the RBI.

(10) **EFTPoS (Electronic Funds Transfer at Point of Sale)**: The late 1980s brought the introduction of EFTPoS. Under this system a customer presents the shop with a card which is fed into a machine which automatically debits the amount of the sale from the customer's bank account.



CHAPTER



REGIONAL RURAL BANKS

On the birth anniversary of Mahatma Gandhi on October 2, 1975, Regional Rural Banks were established with a view to stepping up rural credit, in our village. The Government of India appointed, a working group under the Chairmanship of M. Narasimham, the Deputy Governor of the Reserve Bank of India to review the flow of institutional credit to the people in rural areas. The committee was appointed to study the availability of institutional credit to the weaker section of the rural population and to suggest alternative agencies for this purpose. The committee concluded that the commercial banks would not be able to meet the credit requirements of the weaker sections of the rural areas in particular and rural community in general. Alternatively the Working Group suggested that a new type of banks should be established. These banks would combine the characteristics of both the cooperatives and commercial banks like a cooperative bank would possess local knowledge and familiarity with the rural problems and like a commercial bank should use modern techniques and organisational abilities to mobiles deposits, make advances and access to money market. The government accepted the recommendations of the working group and passed an ordinance in September 1977 to establish Regional Rural Banks.

Need to Establish Regional Rural Banks :

The important need and objective of the RRBs was to give credit and other facilities to the small and marginal farmers, agricultural labourers and artisans, who had, by and large, not been adequately served by the existing credit institutions namely, cooperative banks and commercial banks:

(i) *Co-operative Banks* : So far as the cooperative credit structure is concerned, it lacks the managerial talent, post credit supervision and the loan recovery. They are also not in a position to mobilize necessary resources.

(ii) *Commercial Banks* : These banks are mostly centralized in urban areas and are urban-oriented. Although these can play a crucial role so far as the rural credit is concerned. For this they have to adjust their methods, procedures, training and orientation in accordance with the rural environment. Further due to high salary structure, staffing pattern and high establishment expenses their operational cost is also higher. Thus, under these circumstances, the commercial banks cannot provide credit, to the weaker sections of the rural areas, at a cheap rate.

(iii) *Necessity of a New Institution* : Thus in accordance with the rural requirements, the necessity was felt to establish such an institution *i.e.* a rural-oriented bank which may fulfil credit needs of the rural people particularly the weaker section. It may be also combine the merits of the above two mentioned institutions, keeping aside their drawbacks. The RRBs, as subsidiaries to nationalised banks, are expected in the long run not only to provide credit to farmers and village industries but also mobilize deposits from rural households. They may form an integral part of the rural financial structure in India.

Thus, a rural bank has been treated as an institution to combine the rural touch and local feel. It possesses a familiarity with rural problems and modern business organisation. It contains commercial discipline, ability to mobilize resources and access to the money markets, which the commercial banks have. In short, the institution of rural banks is intended to be "locally based, rural oriented and commercially organized."

Difference Between RRBs and Commercial Banks :

Although the RRBs are basically the scheduled commercial banks, yet these differ from each other in the following respects:

- (i) The area of the RRB is limited to a specified region comprising one or more districts of a state
- (ii) The RRBs grant direct loans and advances only to small and marginal farmers, rural artisans and agricultural labourers and others of small having small means for productive purposes.
- (iii) The lending rates of RRBs are not higher than the prevailing lending rates of co-operative societies, in any particular state. The sponsoring banks and the Reserve Bank of India provide many subsidies and concessions to RRBs to enable it to function effectively.

Organisation :

The RRBs have been established by 'Sponsor bank' usually a public sector bank. The steering committee on RRBs identifies the districts requiring these banks. Later, the Central Government sets up RRBs with the consultation of the state government and the sponsor bank. Each RRB operates within local limits with such a name as may be specified by the Central Government. The bank can establish its branches at any place within the notified area.

Capital :

The authorized capital of each RRB is Rs. 5 crore which may be increased or reduced by the Central Government but not below its paid up capital of Rs. 25 lakh. Of this 50 percent is subscribed by the Central Government, 15 percent by the State Government and 35 percent by the sponsor bank. At present the formula for subscription to RRBs has been fixed at 60:20:20 between central government, state government and the sponsor bank. The Central Government's contribution is made through NABARD.

Management :

Every RRB is managed by a Board of Directors. The general superintendence, direction and management of the affairs and

business of RRBs vests with the nine member Board of Directors. The Central Government nominates 3 directors, the state government has two directors and the sponsor bank nominates 3 directors. The chairman, usually an officer of the sponsor bank but is appointed by the Central Government. The Board of Directors is required to act on business principles and in accordance with the directives and guidelines issued by the Reserve Bank. At the State Level, State Level Coordination Committees have also been formed to have uniformity of approach of different RRBs.

Responsibilities of Sponsor Bank :

The Sponsor Bank shall help and aid the RRB sponsored by it by : (i) subscribing to its share capital, (ii) training its personnel, and (iii) providing managerial and financial assistance during the first five years or extended period. The sponsor banks are empowered to monitor the progress of RRBs, to conduct inspection, internal audit and scrutiny and to suggest corrective measures, as and when necessary.

Resources :

The important resources of RRBs are: (i) share capital, (ii) deposits from the public, (iii) borrowing from sponsor banks, (iv) refinance from NABARD.

The Reserve Bank of India has put RRB on par with the cooperative banks for refinance facilities *i.e.* 2% below the bank rate. Like commercial banks, the RRBs, have been made eligible for accommodation against a mere declaration of eligible loans and advances by them. Further the RRBs have also been granted the status of scheduled banks by the Reserve Bank. They are allowed to maintain cash reserves @3% of their demand and time liabilities till December, 2002.

The RRBs are allowed to offer 1½ percent additional rate of interest on their deposits over the rate offered by commercial banks. The deposits of these banks are also insured by Deposit Insurance and Credit Guarantee Corporation of India Ltd., this has been done to protect the interest of the depositors.

Functions :

The RRB are required to perform the following major functions or operations:

(i) **Operations Related to Agricultural Activities :** To grant loans and advances to small and marginal farmers and agricultural labourers, whether individually or in groups or to cooperative societies including agricultural marketing societies, agricultural processing societies, cooperative farming societies, primary agricultural societies for agricultural purposes or for other related purposes.

(ii) **Operations Related to Non-Agricultural Activities :** Granting of loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade, commerce and industry or other productive activities within its area of operation.

The RRBs now also meet the consumption needs of small and marginal farmers and other borrowers of small means for certain specific purposes such as education, medical expenses, recreation *etc.*

Performances and Achievements :

Consequent upon the recommendations of the Working Group on Rural Banks, 5 RRBs were initially set up in 1975. Their number at present is 196 covering 23 states. The number of branches rose from 17 to 14,500 and the number of districts covered from 12 to 427 over the period June 1975 to June 2002. The RRBs has raised aggregate deposits of Rs. 43,220 crore and had advanced Rs. 15,794 crore (up to March 2002) by way of short term crop loans, long term loans for agricultural activities, for rural artisans, for rural artisans, village and cottage industries, retail trade and self-employed, consumption loan *etc.* Over 95 percent of the loans of RRBs, were provided to the weaker sections. State wise, the

largest number of offices in a single state is to be found in Uttar Pradesh.

So far as the financial performance is concerned, out of 196 RRB, only 67 banks *earned* marginal profit. The process of rehabilitation and recapitalization of RRB was initiated in 1994-

95. During 1997-98, capital support to the extent of Rs. 200 crore was given by the Reserve Bank to 90 RRBs.

The RRBs earned an operating profit of Rs. 789 crore and net profit of Rs. 619 crore in 2008-2009.

The purpose-wise distribution of loans and advances of RRBs as at end March 2002 shows that agricultural loans accounted for 45.7% of total loans and advances of Rs. 7,217 crore in 2009. Of the Agricultural advances crop loans accounted for 51% while terms loans 49%.

RRBs have, further, to play a crucial role in our rural economy, as they have to act as alternative agencies to provide institutional credit in rural areas. In course of time, they are intended to eliminate money-lenders altogether. However, they were not set up to replace cooperative credit societies but to supplement them. In the last 24 years, RRBs have been active participants in programmes designed to provide credit assistance to identified beneficiaries. Under the new 20-point programme, IRDP and other special programmes for scheduled castes and tribes have been launched. They are also implementing differential rate of interest schemes for the weaker sections, physically handicapped persons who are gainfully employed can secure finance for the RRBs for the purchase of artificial limbs, hearing aids, wheeled chairs *etc.*, subject to a maximum of Rs. 2,500 per borrower.

Problems of Regional Rural Banks :

The RRBs have done an important job in mobilising the savings of the small farmers, artisans and agricultural labourers. The presence of the banks has helped to develop banking habits among rural masses. In spite of the progress made, the RRBs have been facing the following problems.

(1) *Problems related to Organisation* : Since the RRBs have been sponsored by various agencies, this has brought a lack of uniformity in their functioning. It has also resulted in lack of support from the state governments and lack of proper monitoring by sponsor banks. Secondly, the area restriction has also brought a constant in its way. Thirdly, proper systems and procedures within the

institutions of RRBs are also lacking. Fourthly, no proper attention has been paid towards the recruitment and training of RRB staff. Fifthly, the growth of these banks seems to be unplanned and many of its branches have been opened under the pressure of the state governments. All these have resulted in many problems related to their control and management.

(2) *Problems related to Recovery* : The recovering position of these banks is also not up to the mark rather it is bad. Their recovery ranges between 51 percent and 61 percent. Thus over dues also vary between 39 percent to 49 percent. The factors responsible for this high incidences of over dues are both internal and external. The internal factors are: defective loan policies, weak supervision, lack of interest towards recovery, non linking of lending with development and failure to ensure the proper end use of the loans. The external factors include political interference, intentional default, less legal and administrative support from the state governments in the recovery of loans etc.

(3) *Problems concerning Rising Losses* : As mentioned above that of the 196 RRBs, 152 banks have shown continuous losses. The reasons for these mounting losses are: (i) These banks mostly advance loans to weaker sections, from where the interest earned on loans is the lowest in the banking system. (ii) There is a high cost of servicing for a large number of accounts, this also adds to the losses. (iii) The opening of branches of these banks, year after year, has added to the overhead costs without proportionate increase in income. (iv) The non-availability of trained and competent staff has also posed a serious problem. (v) The economic environment of many branches of these banks is not up to the mark.

(4) *Problems concerning Management* : As all the RRB institutions have been set up at the district level, the sponsor banks have deputed only the middle-management staff to look after them. These deputed staff member are not in a position to take independent decision in this new environment. Further, the meetings of the board of directors of RRBs are not held regularly and a large number of non-official directors do not show much interest in the working of these banks. Then there are other numerous problems that arise

due to multi-agency control of these banks and their functioning is also not uniform in the all states/districts. .

(5) *Branches of Sponsoring Banks* : The sponsoring banks are also running their own rural branches in the very area of operation of the RRBs, this has given rise to certain anomalies and to avoidable expenditure on controls and administration.

Suggestions for Improvement :

The above problems faced by the RRBs are quite genuine. However, all these problems have to be solved, thus the following suggestions can be given in this connection.

(1) *Improving the Viability's of RRBs* : According to Narasimham Committee, the problem is one of improving the viability of RRBs without sacrificing the basic objectives for which they were set up. The government should interfere in evolving a rural banking structure which could combine effectively, the advantages of the local character of RRBs with the financial strengt and organisational and managerial skills of the commercial banks.

(2) *Segregation of the Operation of Rural Branches* : The Narasimham Committee has recommended that commercial banks should segregate the operation of their rural branches through the formation of one or more subsidiaries. Each rural subsidiary should have a compact area of operations so as to facilitate recruitment and deployment of manpower.

(3) *Merger With Sponsor Banks* : Khusro Committee suggested that these banks should be merged with sponsor banks. Such merger will not only be able to strengthen their delivery system but will also enhance their deposit raising capability. But according to Prof. M.L. Dantawala, such merger will not solve the problem of losses of RRBs, it will only "conceal" these losses.

(4) *Interest Rate* : The interest rate structure of RRBs should be in line with those of commercial banks.

(5) *Earn Higher Level of Interest Income* : NABARD should help RRBs to earn higher level of interest income for their surplus cash balances and for their funds presently invested in government securities.

(6) *Winding up of Loss-suffering Institutions* : Many of the RRBs have accumulated huge losses; and in few cases, the losses have eroded even a part of their deposits. Thus, there is a strong case for winding up such insolvent institutions.

The Kelkar Working Group in its report in 1986 has pointed out that RRBs are eminently suited for the jobs envisaged for them. Hence, there is urgent need to revitalize the RRBs by augmenting their resources, rationalizing the lending procedure, imparting training to the staff and getting cooperation of state governments.

T.T. Velayudhan and V. Sankaranarayan say that "RRBs are not just rural credit agencies. They are more than that, they are a fruitful exercise in bank-led rural growth."

Restructuring of RRBs :

To solve the problem of losses of RRBs and improve their viability, efforts have been made in recent years to restructure their operations and infuse fresh capital into them. The Reserve Bank of India appointed the M.C. Bhandari Committee to suggest measures for restructuring RRBs. As recommended by the Bhandari Committee, 49 RRBs were taken for restructuring and revival in 1994-95. Action was initiated through developmental action plans by NABARD on the managerial, operational and operational restructuring of RRBs and cleansing of their balance sheets over a five-year time span on the basis of the rolling plan concept.

The Basu Committee set up by NABARD recommended in December 1995 the selection of 68 RRBs for comprehensive restructuring under Phase II. The initiatives were primarily in the areas of interest rates, relocation of branches, credit allocation, direction of credit and manpower policy in simultaneity with the infusion of capital. The Government of India released a sum of Rs. 1,867.65 crore between 1994-98 and 1998-99 for the recapitalization of RRBs.

In addition, additional equity support of Rs. 305.3 crore was provided in 1998-99. In 1998-99, 175 of the total of 196 RRBs stood fully or partially recapitalised while 2 RRBs did not require support. Only 19 RRBs were left out side the ambit of the recapitalization

programme. Further the issued share capital of RRBs has been raised from Rs. 75 lakh to Rs. 1 crore NABARD monitors the working of RRBs as regards productivity, cash management, advances portfolio and recovery performance. NABARD has devised a package of short-term measures for RRBs. These are :

- (i) They are freed from their service area obligations.
- (ii) They are permitted to increase their non-target group financing from 40 percent to 60 percent.
- (iii) They are allowed to relocate some of their loss-making branches at agricultural produce centers, market yards, mandis *etc.*
- (iv) Freedom given to them to open extension counters.
- (v) Permission has also been granted to them to upgrade and deepen the range of their activities to cover non-fund activities.

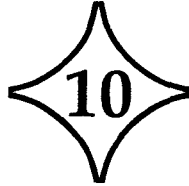
It is hoped that with their restructuring the RRBs will be able to function more smoothly in coming years.

Asset Quality of Regional Rural Banks :

There have been major improvements in the quality of assets of Regional Rural Banks (RRBs). This is due to increase in debt recovery. In order to reduce non-performing assets (NPAs) and improve debt recovery, RRBs have started One Time Settlement Schemes from 31st march, 2009. As a result, debt Collection has increased from 81% to 89%. Therefore, the efficiency of RRBs has improved considerably.



CHAPTER



CREDIT CREATION BY COMMERCIAL BANKS

The commercial banks as the 'creators' of bank credit influence significantly the country's money supply. Accordingly, an understanding of the nature and activities of commercial banks is essential to an adequate grasp of the working of the modern monetary system. Actually speaking, monetary management consists largely of actions by the monetary authorities to influence the activities of commercial banks. In the present chapter, we shall examine the process by which commercial banks create credit and the limits to credit creation by them.

Money is an asset of the holding public. It is a liability of the banking system and the government. However, it is not all the liabilities of the banking system that are money, but only those that serve as media of exchange, namely currency and the demand deposits.

Demand Deposits as Money :

Commercial bank deposits are of following two types: demand deposits and the time deposits. The demand deposits on which cheques are issued are also known as cash deposits or current

deposits. A demand deposit is the obligation of a bank to pay a certain sum of money to a specified individual (the depositor) on demand. The deposit, as we know, is a claim against the bank by the depositor, a debt owed by bank to depositor. The claim is valuable to the depositor, not chiefly because it can be converted into cash, but because it can be transferred to others as a means of payment. Time deposits, on the other hand, are those deposits of money, which can be withdrawn only after a given period of time. In the case of demand deposits, the depositors keep their money in a bank mainly for the sake of convenience in transactions and the settlement of debts. In the case of time deposits, however, the depositors expect an interest income also.

Demand deposits are, therefore, almost as good as cash money. The depositor can convert a part or the whole of the current account into currency notes at any time, *i.e.*, it can convert its claim against a commercial bank into a claim against the central bank (paper money). Time deposits, on the other hand, are to be regarded as assets from the point of view of the depositors. They are not money, since their owners have relinquished their right of free disposal for a fixed period of time. Present-day money consists of claims. Although time deposits also represent claims on banks, but they are not as 'liquid' as demand deposits. They can be turned into money only after some inconvenience or loss of interest. They are, therefore, treated as 'near money' only. They constitute a part of total monetary resources, but not as a part of total money supply.

The view that bank deposits, as far as their economic impact is concerned, are not different from any other type of money, has taken a long time to be accepted. The thesis that bank deposits are money, and that banks by extending credit create money, ran into great difficulties as long as current opinion stuck to the view that money derives its valuableness from its intrinsic worth. The metallic interpretations denied that fiduciary means of payment could be regarded as money and conveyed to them the attributions of 'money substitutes. Even with regard to the paper notes issued by some of the commercial banks in the earlier period there was a strong controversy between the supporters of the currency principle and

the banking principle. Under present-day conditions, however, there exists no controversy on the subject. There is no theory of bank credit separate from the monetary theory. It is accepted by all that both central banks and commercial banks are in a position to grant the use of purchasing power, without thereby deflecting a corresponding amount from somebody else's disposal. In doing so, they create money, and any consequences of their action affect the impact that money produces on the economy.

Primary and Derivative Deposits :

Demand deposits can be classified into following two categories : primary and derivative or passively and actively created deposits.

Primary deposits arise from the actual deposit of cash or cheques and other claims on cash in a bank account. These are the individual money reserves entrusted to the banks to be drawn upon and replenished at the will of their owners. The customer's decision to deposit the cash in the bank account is the real and active force in creating the primary deposits. Since the banks remain passive in determining the size of these deposits, these are known as passively created deposits. The creation of primary deposits only changes common cash into bank money or demand deposit, the community's total money stock remains unchanged.

Derivative deposits are actively created by the bank by creating claims against itself in favour of a borrower or of a seller of assets or securities acquired by the bank. In other words, derivative deposits arise from granting of loans or purchases of securities or assets by the bank. Since a bank generally creates the volume of derivative deposits (either through loans or purchases) based on the strength of primary deposits, the derivative deposits are also known as *secondary deposits*. A derivative deposit, since it is actively created by the bank, increases the community's ownership of demand deposits, without causing any reduction in the people's holding of currency; hence it results in an increase in the total stock of money with the community. The total amount of purchasing power at the disposal of the community is clearly increased by the amount of the derivative deposit. *The creation of derivative deposits is thus, identical with what is commonly called the creation of credit by commercial banks.*

Usually when a bank grants a loan or buys securities (bills, bonds, debentures, etc.) from the market, it does not pay in cash immediately, but opens demand deposit accounts in the names of the borrowers and the sellers of securities. It is due to this practice that the loans and investments (*i.e.*, holding of securities) made by the banks create an equivalent amount of bank deposits. Thus, loans create deposits and the initiative in the creation of these deposits lies with the banks.

Commercial banks are, thus, both intermediaries and money creators. As intermediaries, they transfer resources given to them by the shareholders and depositors to borrowers, much the same as other financial institutions do. But they have the power to lend out not only the cash transmitted to them, but also deposit money which they create in the process of granting loans or making investments. Generally, the intermediary and money creation activities of banks are closely intertwined. Cash received by the banks is rarely loaned out directly. Ordinarily it becomes part of a pool of cash reserves that serve to support the bank's outstanding deposit liabilities. It enables the banks to acquire additional loans and investments in exchange for deposits, which involves the banks in both intermediary and money creation activities. Sayers aptly says : "Banks are not merely purveyors of money, but also, in an important sense, manufacturers of money".

The bank credit and bank deposits are very closely related with each other, that they represent, roughly speaking, two sides of the same coin, the balance sheets of banks. With regard to the question whether loans make deposits or deposits make loans, two kinds of answers have been given for the puzzle. One answer is that from the point of view of a single small bank, it is true to say that 'deposits make loans', but from the point of view of the banking system as a whole, it is more true to say that 'loans make deposits'. The second answer, considering the banking system as a whole, views the relationship as a circular one. It holds that it is true to say both, that deposits make loans and that loans make deposits. Both are interdependent or jointly determined variables, neither is a cause or effect. Both are determined by some other factors and certain behavioural relations of the system. The task of the theory is, thus,

to identify these factors and relations and explain how their interaction determines the size of bank deposits and credit.

A bank's power to create derivative deposits is based on the strength of primary deposits. Some primary deposits are received and some withdrawn from the banks every day. New deposits thus tend to balance everyday withdrawals. The bank knows by experience that the total amount of cash required to meet daily liquidity is only a fraction of primary deposits. It is believed that if the bank enjoys the confidence of the depositors and the bank managers are judicious in their loans and investments, it can function properly by keeping not more than 2 per cent cash reserves against deposits. Thus most part of the cash volume which remains idle can be used fruitfully for making loans and investments. It is the excess funds that enable the banking system to create credit or derivative deposits.

The bank's assets or reserves may be classified into primary and secondary reserves. The primary reserves consist of cash in hand, reserves with the central bank and the balances with other banks. These may be classified as statutory or legal reserve and working reserve. The former refers to the minimum cash reserve or ratio that each bank has to maintain by law against its primary deposits. The latter comprises cash holding in excess of legal reserves. The primary reserves are intended for meeting the cash demand of the depositors and transfer of net deposits to other banks.

The secondary reserves, on the other hand, are intended to supplement the primary reserves in case of extraordinary withdrawals of deposits. They include the securities held by a bank which can be converted into cash without loss. The solvency and liquidity of a bank depend on the size and character of its primary as well as secondary reserves. A bank can, thus, lend and invest up to the limit of its excess reserves (*i.e.*, total primary reserves less legal reserves and provisions for ensuring the solvency of the bank). The lending and the investment operations of a bank initiate the process of "multiple expansion of bank deposits" which continues until the initial deposit is leaked out from the banking system. The size of the multiple will tend to be larger as the fractional-reserve requirement is smaller.

Process of Multiple Credit Expansion :

(i) *A Monopoly Bank* : When examining the process of the creation of credit or bank money it is useful to start with the model which is simplest theoretically. Let us assume a situation in which there is only one bank, and in which all payments are made without using cash. All payments are made by means of book-transfers from one current account to another. There is, thus, no external drain of cash as a consequence of the expansion of demand deposits.

Suppose, this bank receives a Rs. 1,000 addition to its reserves through a primary deposit in cash. Now, if the bank keeps 100 per cent cash-reserve balances, it cannot create any extra money out of this new deposit of Rs. 1,000. It will simply change currency into demand deposit up to the extent of Rs. 1,000. The growth of bank money (M) is just offset by the decline of currency in circulation (M). Practically, however, the bank does not have to keep 100 per cent reserves. The bank after all is not a mere custodian of deposits. Its main objective is to earn profit by making loans and investments to the maximum possible extent. Suppose that the law requires it to keep only 20 per cent reserve, then normally it will not find it profitable to keep much more reserves than the law requires.

Thus, with a minimum reserve ratio of 20 per cent, each rupee of the excess reserve can support a volume of derivative deposits five times as large. Now, can this bank expand its loans and investments by Rs. 4,000? Yes, it could if all the derivative deposits remained with it. Looking at the position of our monopoly bank from the standpoint of its balance sheet, it will be in equilibrium when it has expanded its earning loans and investments to the point where its reserves are in a one to five ratio to its deposit liabilities. These conditions would be met if the balance sheet of our monopoly bank were as follows :

*Table I.**Balance Sheet of a Monopoly Bank with no Cash Drain*

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Deposits	5,000	Reserves	1,000
		Loans and Investments	4,000
Total	5,000	Total	5,000

Total assets equal total liabilities and cash reserves meet the legal requirement of being 20 per cent of total deposits. The initial increase of Rs. 1,000 in the reserves remains with the bank, available to support additional derivative deposits. Thus, whenever an addition of Re. 1 to the reserves produces Rs. 5 of new demand deposits (the expansion ratio being 5 : 1), the net creation of money (M') is only Rs. 5 – Re. 1 = Rs. 4. Had there been no reserve requirements, whether legal or customary, the bank could have created any amount of money it desired.

(ii) Let us change the assumptions of our case a little so as to bring it closer to reality. We have thus far examined the multiple expansion of demand deposits by a monopoly bank on the assumption that all transactions are settled by means of cheques and no cash is ever used. In practical life, the cheques may be used, but there are still some money transactions for which cash may be demanded. Actually no one will borrow money and pay interest just to hold it all in the bank. The borrower spends the money on so many things and ultimately it has to be paid out of the bank. The loss of cash by a bank expanding its investments is even more clearly seen if the bank buys a bond rather than making a local loan. The bank cannot buy a bond and keep its cash at the same time. It will be just like eating the cake and having it too. Table 1, therefore, does not show the correct picture of what a single bank operating in an economy can do.

If the expansion of demand deposits by the bank is likely to be accompanied by an outflow of cash into hand-to-hand circulation, the process of expansion will bring with it a steady reduction in the size of bank reserves. This will cause the expansion process to come to a halt at a lower level of deposit expansion than otherwise.

With 20 per cent of its deposits as reserves, the bank can acquire earning assets (loans, bonds, or mortgages, etc.) worth Rs. 800. The whole of this amount will be withdrawn when cheques are presented for payment. Now this bank will be in equilibrium when its balance sheet looks as shown in Table 2.

Table 2.

Balance Sheet of a Monopoly Bank with Cash Drain

Liabilities	Rs.	Assets	Rs.
Deposits	1,000	Reserves	200
		Loans and Investments	800
Total	1,000	Total	1,000

As regards this bank, its legal reserves are just enough to match its deposits. There is nothing more it can do until it receives some more new deposits. This bank, having retained only Rs. 200 of cash (*M*), has added Rs. 1,000 of bank deposit (*M*) to the public's total. Its activity has, thus, created a net increase of Rs. 800 in aggregate money supply. It is obvious that this bank with cash withdrawals or drains can create one unit of bank money out of 1/5 unit of money in reserve but it cannot create 5 units of money out of one unit. The higher the required reserve, the less will be the bank's ability to create money; with a 100 per cent reserve the bank can create no money at all. The lower the required reserve, the greater will be the bank's ability to create money; with a zero reserve requirement it can create money without limit. The required reserve of 20 per cent is only an assumption. The actual figure at a particular time may be considerably higher or lower than this, depending on the desire of depositors to obtain cash and the requirements, if any, imposed by the law.

In the case of this bank, it has been assumed that all the loans and investments made by the bank are to be paid in cash. This prohibits the bank to lend or invest more than the amount of excess reserves. But if the borrower writes cheques to an amount less than borrowed or if some of the cheques are redeposited in the bank, then the bank will not lose reserves to the full amount, of the loan. Under these circumstances, the bank can now afford to lend more because it still has excess reserves and it is quite safe to make an additional loan equal to the current excess reserves.

Banking System as a Whole : We have above that an individual bank cannot afford to lend more than its excess reserves. No single

bank can invest or lend money that it does not have; and money that it invests or lends soon leaves the bank. But the banking system as a whole can do what each single bank (working alone or in competition with others) cannot do. It can expand its loans and investments many times the new reserves of cash created for it, even though each single bank is lending out only a part of its deposits. How is this possible?

For the purpose of multiple credit expansion, the banking system as a whole can be compared with a single monopoly bank (with many branches) in a closed economy whose balance sheet has been given in Table 1.

Our original bank had received a primary deposit of Rs. 1,000. With 20 per cent reserve ratio, the bank creates derivative deposits (loans and investments) to the extent of Rs. 800, which was equal to its excess reserves. Now we consider this bank as only one of the banks operating in a large number in an economy. The people who sold the bonds or borrowed from this bank will presumably deposit the proceeds in some other bank or pay them to some one else who will make such a deposit. Our original bank is thus under a liability to pay Rs. 800 to some other banks in the system, which may be called collectively as *bank A*.

Now we have assumed that cheques have been written on the original bank for the full amount of Rs. 800 and deposited in other banks (*A*). To the extent that some of these cheques, are redeposited in the original bank, this bank can also be represented in our collective bank *A*. We can also assume that all banks have the same 20 per cent reserve ratio. Thus, out of its new deposits amounting to Rs. 800, the bank *A* will have a reserve of Rs. 160 (20 per cent) and make loans and investments for Rs. 640. The following balance sheet shows the equilibrium position of bank *A*.

Table 3. Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
Deposits	800	Reserves	160
		Loans and Investments	640
Total	800	Total	800

As the borrowers and sellers of securities write cheques on *A*, it will lose Rs. 640 to a new set of banks called collectively bank *B*. Now *B* will have deposits of Rs. 640 and will make loans and investments to the extent of Rs. 512 and add Rs. 128 to its reserves. This process will continue and the balance sheets of the different banks can be prepared accordingly. If we were to follow this process until the excess reserves of Rs. 800 of the original bank were exhausted, we would find that the banking system had been able to create Rs. 4,000 of new deposits in the process. It ends up with final bank deposit five times the reserves it finally retains. The initial deposit of Rs. 1,000 representing an increase of Rs. 1,000 in total reserves, would result in a total expansion of deposits of Rs. 5,000. The final position has been shown in the Table 4 given below.

Table 4. Deposit Creation by the Banking System

<i>Banks</i>	<i>New deposits received</i>	<i>Reserves against new deposits (20%)</i>	<i>Deposits created on the basis of excess reserve (80%)</i>
	Rs.	Rs.	Rs.
Original Bank	1,000.00	200.00	800.00
Bank A	800.00	160.00	640.00
Bank B	640.00	128.00	512.00
Bank C	512.00	102.40	409.60
Bank D	409.60	81.92	327.68
Bank E	327.68	65.54	262.14
Bank F	262.14	52.42	209.72
Bank G	209.72	41.95	167.77
Bank H	167.77	33.55	134.22
Bank I	134.22	26.85	107.37
Total, first ten banks	4,463.13	892.63	3,570.50
Banks J to a	536.87	107.37	429.50
Grand Total	5,000.00	1,000.00	4000.00

The chain of deposit creation can be proved by algebra as follows :

$$\text{Rs. } 1,000 + \text{Rs. } 800 + \text{Rs. } 640 + \dots\dots\dots$$

$$= \text{Rs. } 1,000 [1 + 4/5 + (4/5)^2 + (4/5)^3 + \dots]$$

$$= \text{Rs. } 1,000 \left(\frac{1}{1 - 4/5} \right)$$

$$= \text{Rs. } 1,000 \times 5$$

$$= \text{Rs. } 5,000.$$

As credit creation depends upon the ratio of cash reserves to deposits, the deposit multiplier is $\bar{k} = \frac{1}{r}$ in which \bar{k} deposit multiplier and r = ratio of cash reserves to deposits. For example, if cash reserve ratio is 20 per cent or 0.2, the deposit multiplier is $\bar{k} = \frac{1}{r}, = \frac{1}{0.2} = 5$.

From the above analysis a general formula for deposit expansion for the whole banking system may be established as follows :

$$\Delta D = \Delta a \cdot \frac{1}{r}$$

where, ΔD stands for the multiple expansion in total deposits for the whole banking system, r for the cash reserve ratio and Δa for the initial increase in the primary deposits (with the original bank in illustration). Substituting our assumed values of

$$\Delta Aa = \text{Rs. } 1,000 \text{ and}$$

$$r = 0.2, \text{ we get}$$

$$\Delta D = \text{Rs. } 1000 = \frac{1}{0.2}$$

$$= \text{Rs. } 5,000.$$

The expansion potential can also be expressed on the basis of excess reserves of the banking system (ΔZ). Hence the formula may be rewritten as

$$\Delta D = \frac{\Delta Z}{r}$$

Given r and ΔD , this equation gives the limit to which the banking system can actively create deposits. ΔD is directly proportional to ΔZ and inversely proportional to r . An individual bank which has excess reserves AZ can grant new credit only up to the amount of its excess reserves. But the banking system as a whole can grant new credit up to an amount several times the size of ΔZ . The 'money creation multiplier' or 'money creation coefficient' is equal to the reciprocal of the minimum reserve ratio.

The individual bank serves as only one link in the whole chain. Each bank in the chain creates deposits for some other bank. The normal effect of a loan by bank A in the amount of Rs. 640 is not a permanent increase of its own deposits, but rather a loss of that amount of reserves to bank B . To bank B this looks like any other deposit that increases its reserves. Bank B then creates an additional loan of Rs. 512, which in turn results in loss of reserves of that amount to some other bank.

No single bank in the banking system of a country can create deposits to the multiple of the excess reserves, but working together (not in collusion but simply with the same object guiding each of them) banks as a whole can do so.

One could follow through the similar process by which all banks simultaneously contract money for each rupee of reserve withdrawn from the banking system. Suppose that at a time when they hold no reserves in excess of legal requirements, the banks suffer an initial loss of reserves equal to Aa . Now the banks may have to reduce their demand deposits (ΔD) by reducing their loans and security holdings. The process we have explained above for credit expansion will be reversed for credit contraction. The minimum required contraction would be reached when the banks have reduced their demand deposits so much that their required reserves ($r\Delta D$) have decreased by an amount equal to the actual loss of reserves (Δa). Just as a rupee of excess reserve may result in the creation of several rupees of deposits, the loss of a rupee of reserves may result in a several-fold contraction of deposits. If the banks are completely 'loaned up' (their total reserves are required reserves), then the loss of a rupee of reserves must be accompanied

by bank action either to (1) acquire additional reserves, or (2) reduce deposit liabilities

Do the banks create or destroy deposits all alone? The demand deposits are actually created jointly by the bank's willingness to accept a demand liability and the customer's willingness to hold a deposit. The whole operation actually involves four parties : the customers or the depositors, the banks by keeping only a fraction of their deposits in the form of cash, the public and private borrowers who provide earning assets to the banks for their excess cash, and the central bank which determines the cash-reserve ratio and the credit control policy. There are, thus, some practical limitations on the power of banks to create credit. The limit to potential credit expansion by the banking system, barring recourse to the central bank, is determined solely by the size of excess reserves, by the minimum reserve ratio, and the payment habits in the non-banking sector expressed by the cash withdrawals from the banks.

Practical Limits to Deposit Expansion :

Our hypothetical case of multiple deposit creation shows the maximum limits, that might be reached if every rupee of excess reserves were put to work. In actual practice, it is not likely that such a perfect co-ordination would occur. The results we have derived from our illustration are based on the following important assumptions :

1. That there are no 'cash drains' or leak ages of cash from the banking system in the course of credit expansion. Credits granted to the customers must never be in the form of cash and all clearings take place on the books of the banks.
2. That the funds created by the expanding bank on the basis of additional reserves are transferred in full amount to other banks.
3. That all banks stick strictly to their minimum legal reserve ratios.
4. That all deposits liabilities of the banks are in the form of demand deposits only. This assumption permits us to disregard the effects on bank deposit expansion of movements between different types of deposits.

5. That all the banks must move in step. A rise in reserves will usually affect almost all the banks at the same time. They all receive some new deposits at about the same time. They all have excess reserves in the first instance, and all together make loans or buy securities.
6. That all the banks always remained "loaned up", that is, they are always in a position to adjust their earning assets and deposits so as to keep their excess reserves at a zero level.
7. That the behaviour and the credit control policy of the central bank remain unchanged.

Given the above assumptions, each rupee of reserves can support $1/r$ rupees of deposits so that the banking system as a whole can create deposits equal to a multiple of its excess reserves. In practice, however, these assumptions may not be valid and the actual amount of credit expansion may differ markedly from the amount estimated in our illustration. The practical limit to deposit expansion are detailed below:

Cash Drain : The extent of credit creation depends on the amount of cash which commercial banks hold. The larger the amount of cash with the banking system the greater will be the excess reserves and larger will be the credit creation power of the banks. It has been assumed that in the chain process of multiple credit creation all the reserves lost by a bank are gained by another bank and no payments are made in cash. In practice this may not be the case, for some reserves may be drained away from the banking system.

It is quite possible, and even likely, that somewhere along the chain of deposit expansion some individuals may withdraw a part or all of the proceeds in their accounts in cash. The desire of the depositors and the borrowers to obtain cash will depend on the structure of the society, the relative advantages and disadvantages of using cash as against cheques, the faith of the community in the banking system and the stability of the economy. It is, therefore, subject to change over time. An outflow of cash from the reserves of the banks will bring with it a steady reduction in the size of bank

reserves (R). This will correspondingly reduce the ability of banking system to expand deposits.

The rate at which the public converts demand deposits into currency with the expansion of deposit money (*i.e. currency-deposit ratio*) may be termed as C . The actual outflow of cash will be equal to ($C.\Delta D$) and cash absorbed in required reserves to support the newly demand deposits will be ($r.\Delta D$). The introduction of the currency drain means that the excess reserves (ΔB) are being used to meet the currency drain and the required reserve. Thus,

$$\Delta R = r\Delta D + C\Delta D$$

$$\Delta R = \Delta D + (r + C)\Delta D$$

$$\Delta D = \Delta R \cdot \left(\frac{1}{r + C} \right) \text{ or } \Delta D = \frac{\Delta R}{r + C}$$

In terms of the earlier example, if the total excess cash reserves R (Rs. 1,000) and the required reserve, r , (20%) remain as before and C is taken as 25 per cent, the amount of demand deposit expansion (ΔD) will be Rs. 2,222 only instead of previous Rs. 5,000. It is quite apparent from this that the presence of a cash drain amounts to an increase in the reserve requirement and thus reduces the expansion potential of any given volume of excess reserves.

Excess Reserves : We have assumed that the commercial banks maintain only as much reserves as they are legally needed to maintain. In actual practice, however, the banks usually maintain some 'excess' reserve in addition to the legal reserve requirements. All commercial banks need some extra cash to meet withdrawals. Some excess reserves may also be maintained with the central bank in order to have funds through which clearing can be carried out, money transfers made and so on. The level of excess reserves also depends on the attitude of banks toward the interest rates. In case of low interest rates banks may prefer liquidity over profitability of their reserves. Because banks are so dissimilar in size, location, legal status, type of customers, and so on, the proportion of deposits held in customary reserves undoubtedly varies considerably from bank to bank. Higher the cash reserve ratio to be maintained, smaller

will be the relative excess funds and smaller will be the volume of credit creation and vice versa.

Different Types of Deposits : It has been assumed that all the deposits are in the form of demand deposits only, while actually a fairly large part of total deposits is in the form of time deposits or savings deposits. Since time deposits are not with draw able by cheques and do not serve as money, the result of an increase in time deposits is to reduce the money supply. A -shift from demand to time deposits limits the potential expansion of demand deposits. This is because a part of the banking reserves is “used up” to meet reserve requirements against the additional time deposits, which are only money substitutes.

Monetary Policy of the Central Bank : The central bank has the power to use various methods of credit control and thus influence the volume of credit expansion or contraction by banks. A restraint on bank lending during the boom is a basic function of the central bank. The central bank can influence the size of the reserves of the banks by the use of quantitative credit controls, *viz.*, bank rate variations, open market operations, and variations in the cash reserve ratios. A narrow reserve base can only support a relatively small super-structure of credit that is raised above it and vice verse.

Willingness to Lend : The ability of a bank to lend is not the same as its willingness to lend. Sometimes the banks feel reluctant to lend. This may be due to a lack of faith on the part of the bank in the individual soundness of the prospective borrower. The bank cannot lend to everyone who wants money; it will try not to make loans that it thinks are likely to be defaulted. Sometimes the bank may lose faith not in the individual borrower, but the general business situation. In a critical business situation, the bank may decide not to make the loans except the soundest ones. It may also decide to hold an exceptionally large amount of excess reserves in order to satisfy its desire for liquidity. If it fears a “run”, it is likely to wish to have extra funds-immediately available. Thus, banks do not always expand as much as they can. The key financial considerations that influence the allocation of credit are the risk of default and the net rate of return. Each of these two factors incorporates several other factors.

Willingness to Borrow : In order to make loans the banks must find customers who wish to borrow. If businessmen have low demand for loans, or if securities are not offered for sale in adequate number, bank; will obviously riot be able to make loans. The excess reserves of the banks will not be used at a base for increased deposits. Thus, the amount of borrowing by the customers sets a limit to the amount of expansion of credit. There may be very low, sometimes only negligible, demand for loans in the times of depression when even a sufficient reduction in the interest rate may fail to create enough demand for loans. Credit creation, therefore, will be larger during a period of business prosperity and it will be smaller during a depression.

Thus, there are many practical limits to credit creation by the commercial banks. This shows that there is nothing mechanical and completely accurate about using a 5 : 1 or any other fixed ratio for multiple credit creation. The banks cannot take their own independent decisions. Their ability to expand loans and deposits is mainly limited by the amount of their reserves and by legal reserve requirements, both of which can be influenced by the central bank. The amount by which credit may expand with a given amount of excess reserves also depends on the public's preference among the alternatives of demand deposits, time deposits, or currency. Thus, for the purpose of credit creation this alone is not enough that the banks must somehow receive new reserves and that they may be willing to make loans or buy securities rather than hold new reserves. The process of multiple credit creation described in our simplified explanation can, therefore, be taken to indicate that an individual bank will be *able* to expand its lending safely by an amount equal to its excess reserves. If each bank adopts the safe rule of thumb of expanding by the amount of its excess reserves, a part of the additional reserves will pass over to other banks until, in the end, the increased reserves are spread over the system as a whole, supporting a larger volume of loans and deposits.'

Do Banks Really Create Credit?

So far we have explained the process called "multiple expansion of bank deposits", which implies that banks can create

credit by lending more than what is deposited with them. The practical bankers, however, argue that they do not (and cannot) create credit or deposits. They only pass on to investors the savings that their depositors bring to them. They can invest only what is left with them after allocating a part of their deposits to their cash reserves. They assert that they don't create anything.

Walter Leaf, a practical banker, and Edwin Cannan, an economist, have contended that banks do not create credit at all. According to Walter Leaf, when a bank creates a deposit, the deposit amount is likely to be withdrawn sooner or later; hence it cannot lend beyond the amount deposited by customers with it. Thus, banks do not create credit; they only lend the money their depositors entrust to them.

Dr. Cannan has taken the analogy of a cloak room. Suppose 100 members of a night club attend regularly and bring one umbrella each which they deposit at the cloak room of the club. The man at the counter knows by experience that not more than 10 members demand umbrellas during an hour. He may, therefore, rent out 90 umbrellas for the duration of the night and make some money. Can we say that in this way he has created 90 umbrellas? Certainly not. Similarly, when a bank lends apart of its deposits, this does not mean that it has created money. "The most abandoned cloak room attendant cannot lend out more umbrellas than have been entrusted to him, and the most reckless banker cannot lend out more money than he has of his own plus what he has of other people".

These arguments seem to be valid from the point of view of an individual bank. But, as we have already explained, the banking system as a whole can do what each individual bank cannot do. Even though each bank can lend out only a fraction of its deposits, the banking system as a whole can expand its loans and investments in a proportion higher than that of the new reserves of cash created for it. All that is needed for credit creation is that the banks must somehow receive new reserves, they must be willing to make loans and investments rather than hold new excess reserves, someone must be willing to borrow or to sell securities; and the excessive cash drain must not deplete the banks of their additional reserves.

The fact that commercial banks can create credit was not accepted in the days when bank credit was in its infancy. They were considered merely as intermediaries who helped in passing the funds from one holder to another. One of the first theorists to oppose this view was Macleod in his book *The Theory and Practice of Banking* (1856). Hawtrey and Robertson in England and Schumpeter and Kahn in Germany have given the final push to the general acceptance of the credit creation function of the commercial banks.

Credit creation by commercial banks can be analyzed not only theoretically, but in practical terms as well. On practical side, one can easily grasp this fact when he compares the magnitude of bank-deposits with the total amount of cash in country and the cash-reserves of commercial banks. Let us examine the case on the basis of figures relating to our own country, where banking system is not as much developed as in the advanced industrial economies and where there is comparatively heavy 'cash drain' from the additional reserves of the banks. Our central bank has also imposed several restraints with a view to control the credit-expansion by banks.

Aggregate deposits of scheduled commercial banks in India out-standings, as at the end of April 2000, amounted to Rs. 8,86,423 crores (Rs. 1,36,654 crores as demand deposits and Rs. 7,49,768 crores as time deposits with banks). The volume of currency with the public at the same time was Rs. 1,98,742 crores. If the banks do not 'create' their deposits, how has the amount of bank deposits gone beyond the volume of currency with the public when only a part of currency in the country has been deposited with the banks?

Thus, it becomes obvious, both theoretically as well as practically, that the commercial banks create their deposits, The only practical limit is set by the amount of cash available to banks.

Recent Theoretical Developments :

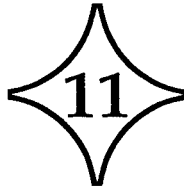
Theorists concerned with the money supply have tended until recently to stick to the mechanical 'money multiplier' approach, extending it to allow for the different reserve requirements against time and demand deposits and the demand for money by financial intermediaries. This approach has been partitioning changes in

the quantity of money among changes in the currency-deposit and reserve-deposit ratios and the reserve base, and changes in the reserve base among changes in reserve bank liabilities and assets. The trend of recent research on money supply has, however, been towards treating these ratios as behaviour relationships reflecting asset choices in terms of the adjustment of actual to desired stocks rather than in terms of changes in flows.

According to Johnson, recent work on the response of the banking system to changes in reserves has departed from the 'money multiplier' approach in three respects *first*, in basing the analysis on the behaviour of the individual bank instead of the banking system; *second*, in applying economic theory to the explanation of the level of reserves desired by the bank and relating its behaviour in expanding or contracting its assets to the difference between its actual and its desired reserves; and *third*, in treating the loss of reserves consequent on expansion as a stochastic process. These innovations are exemplified in articles by Brunner and Orr and Mellon. In contrast to the results of money-multiplier analysis. Orr and Mellon have shown that the marginal expansion ratio will be lower than the average for a monopoly bank, and lower for a banking system than for a monopoly bank; and that for a banking system the marginal expansion ratio depends on the distribution of the additional reserves among banks.

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CHAPTER



CREDIT TO PRIORITY AND NEGLECTED SECTORS

Traditionally, commercial- banks in our country have been giving credit facilities to large commercial and industrial houses. The other sectors of the economy — namely, small traders, farmers, industrialists and self-employed professional persons — were almost totally neglected by them in matters of credit. In other words, their lending policies were highly imbalanced, providing credit facilities to only one or two sectors: the remaining sectors of the economy did not get any bank credit. Because of lack of credit facilities, many sectors of the economy remained backward.

For a long time, there has been a need for the nationalization or control of commercial banking to ensure that it plays a more purposeful role in the economic development of our country. The Government started a scheme of Social Control of Banks in February 1969, which aimed at bringing about some changes in the management and credit policy of commercial banks. Under this scheme, a National Credit Council was set up to perform the following functions in regard to credit planning:

- (i) An assessment of the demand for bank credit from various sectors of the economy;

- (ii) A determination of priorities for the grant of loans and advances and for a consideration of the availability of resources and requirements of priority sectors; and
- (iii) Coordination of the lending and investment policies of commercial banks, cooperative banks and other specialized agencies.

After the enforcement of social control, banks were required to give a larger allocation of credit for three sectors which were designated priority sectors — agriculture, small industries and exports; and targets were laid down by the National Credit Council about the quantum of credit to be given to these sectors. In July 1969, fourteen leading commercial banks were nationalised; as a result, most of the banking sector came under the control of the Government. After nationalization, the Government directed the banks to provide credit not only to the priority sectors but also to certain other sectors of the economy which were not getting any credit facilities from the banks till then. These sectors, called the neglected sectors, were traders, transport operators, self-employed persons and professional persons and students. One of the greatest advantages of the nationalization of banks in India has been the provision of credit facilities to these priority sectors and neglected sectors of economy.

Why these Sectors could not Get Bank Credit in the Past?

Some of the important reasons why these sectors did not get bank credit are as follows :

(i) **Prevalence of Urban Banking:** Banking facilities were available only in urban areas. There were no branches of banks in villages and small towns.

(ii) **Bankers' Apathy towards these Sectors :** Bankers were mainly interested in providing credit facilities to big industrialists and traders; they never cared to provide credit to priority and neglected sectors.

(iii) **Security :** The basis of lending by Indian banks has always been the security of some tangible assets. Thus, those sectors of the economy which were not in a position to provide a tangible security

were deprived of bank credit. This was the reason why small borrowers could never get any credit from a bank and had to rely solely on indigenous bankers and moneylenders.

(iv) *Priority and Neglected Sectors Unorganized* : As compared to the well-organized industrial and trading sectors, the priority sectors were not well-organized. Due to the inadequacy of irrigation facilities, agricultural operations in India depend on rains, which are always uncertain. The business of small entrepreneurs and self-employed professionals is also full of risks — at least in the initial stages. Moreover, these sectors are not in a position to provide any tangible security to banks against advances. Banks, naturally, evaluate an application for an advance on the basis of the type of business conducted by those asking for loans, their repaying capacity, security to be pledged and their future prospects in business. No wonder credit propositions for most of the priority and neglected sectors were not attractive credit propositions for banks.

There were many other important reasons as well; the illiteracy of farmers and small traders, their ignorance of the rules and regulations governing bank credit and the forms to be filled up and of other formalities which had to be observed. They also did not know how to maintain proper accounts of their business transactions.

But after nationalization of banks in 1969, the whole concept of bank lending underwent a change. Banks have abandoned their cautious, conservative and traditional outlook and methods. They have started providing credit facilities to new sections in the priority and neglected sectors. Instead of insisting on tangible security, they now advance money on the basis of a charge on the assets of the borrowers acquired from borrowed funds. Greater importance is now attached to *term loans*. In term lending, the banker examines the purpose of a loan, its economic viability, income-generation from the use of borrowed funds, *etc.* He has now started lending to some small sectors without security. But this change in a bank's credit policy has been made possible by the active direction and control of the Reserve Bank and of the Government, and by the

establishment of the Institutional Guarantee Support system to cover the risks of banks in financing these neglected sectors.

New Concepts and Criteria in Commercial Bank Lending :

As a result of persuasion, directions and guidance of the Central Government and the Reserve Bank, the Indian banking community has adopted new concepts, techniques and criteria for lending to the priority sectors. Important developments, in this field may be summed up as follows :

(1) *Change in outlook* : The outlook of the bankers in favour of the priority and neglected sectors has completely changed after the nationalization of 14 major banks. The bankers are today committed to help the backward sectors. This change in their outlook and spirit has been a significant achievement.

(2) *The consideration of security has undergone radical change*: It is wrong to presume that the bankers do not observe the principle of safety and security while lending funds to the priority sectors and that they lend to all borrowers indiscriminately. They still judge the safety of funds lent as no modern banker can afford to ignore it. However, the concept of safety has undergone a significant change. Traditionally, the safety of funds is ensured by securities a charge over the tangible assets of the borrower, which may easily be liquidated in order to recover the loan in case of default by the borrower. Under the new concept of security, safety of funds is ensured in the following ways :

- (a) A charge over the tangible assets is not altogether dispensed with. In practice, banks like to have a charge over the assets of the borrower as far as possible. If no tangible asset is available for this purpose, banks even grant unsecured advances depending upon the borrower's repaying capacity and ability to make use of the credit. It is to be noted that a charge is preferred on the tangible assets acquired with the borrowed funds and not necessarily over the asset already possessed by the borrower. Thus a person without any tangible assets is also eligible to borrow provided he fulfils other conditions.

- (b) The banker largely depends on the desirability of purpose and economic viability of the project for which credit is needed. The banker examines all aspects of the functioning of the proposed project of the borrower.

Technical ability, managerial competence and integrity of the borrower are the valuable intangible assets on which the banker is now largely relying. The banks now grant credit facilities to really able and talented persons having plan for starting sound projects.

- (c) Institutional guarantee system has been evolved to cover the risks of the banks in financing these neglected sectors. The advances granted to the priority sectors are guaranteed by the Deposit Insurance and Credit Guarantee Corporation of India. This institution guarantees the advances automatically and in bulk provided the conditions of eligibility are fulfilled. Thus the bankers are enabled to take what is called "calculated risk." This system of institutional guarantee enables the banker to share his risks with the Guarantee Corporation.
- (d) Follow-up measures are taken to ensure proper utilisation of the loans given for specific purposes. Adequate arrangements have already been made by the banks to ensure the success of the borrower's enterprise.
- (e) Full information about the borrower and his business is sought by the banker in order to assess the desirability of the loan, the weak features of the working of his business, etc.
- (f) Flexibility and not rigidity is what is required most. The branch managers are expected to dispose of the majority of cases themselves according to their judgment and discretion.

Priority Sectors :

The concept of 'Priority Sector' was evolved at the time of introduction of Social Control on banks in 1968 and subsequent nationalization of major banks in 1969. The scope of activities

included in the term priority sectors has been gradually enlarged over the years. At present different segments of the priority sectors are as follows :

1. Agriculture
2. Small Scale Industries
3. Small Road and Water Transport Operators
4. Retail Trade
5. Small Business
6. Professional and Self-employed Persons
7. State-sponsored bodies for Scheduled Castes and Tribes
8. Education
9. Housing
10. Consumption Loans.

Targets for Lending to Priority Sectors

Reserve Bank has fixed the targets for lending to the priority sectors by commercial banks as follows :

1. *Public and Private Sector Banks*

Total priority sector advances	40% of net bank credit
Total agricultural advances	18% of net bank credit
Advances to weaker sections	10% of net bank credit
2. *Foreign Banks Operating in India*

Total priority sector advances	32% of net bank credit
Advances to small scale industries	10% of net bank credit
Export Credit	12% of net bank credit

It is to be noted that export credit forms part of the priority sector only for foreign banks operating in India. For such banks no sub-target for agricultural advances is prescribed. Instead sub-target is prescribed for small scale industries.

Reserve Bank has also stipulated that if there is a shortfall in priority sector lending from the above targets and sub-targets the bank concerned should deposit an amount equivalent to the shortfall with the Small Industries Development Bank of India at an interest rate of 8% per annum.

In April 1997, Reserve Bank of India decided that out of funds available to all segments of the small scale sector, banks should ensure that 40 per cent are made available for units with investment in plant and machinery up to Rs. 5 lakh 20 per cent for units with investment between Rs. 5 lakh and Rs. 25 lakh and the remaining 40 per cent for other small scale industries.

Definition of Weaker Sections : Weaker sections in priority sector comprise of following :

- (a) small and marginal farmers with land holdings up to five acres
- (b) landless labourers
- (c) tenant-farmers and share-croppers
- (d) artisans
- (e) village and cottage industries where individual credit requirements do not exceed Rs. 25,000
- (f) beneficiaries of Integrated Rural Development Programme (IRDP) and SEPUP
- (g) beneficiaries belonging to Scheduled Castes/Scheduled Tribes and
- (h) Differential Rate of Interest (DRI) beneficiaries whose family income from all sources does not exceed Rs. 3,000 per annum in urban and semi-urban areas or Rs. 2,000 per annum in rural areas.

New Schemes of Bank Finance to Priority and Neglected Sectors:

After nationalization, most of the commercial banks have started new schemes to finance priority and neglected sectors, which were undeveloped parts of the economy and were not in a position to provide the securities required. The banks now provide credit to these sectors under relaxed security conditions. Some of the important features of these schemes are as follows :

(a) **Loans to Farmers for Agricultural Purposes :** Banks provide credit facilities to farmers for the purpose of seeds of high-yielding varieties, fertilizers, pesticides, dairy and farm animals, tractors and other farm machinery, installation of tube-wells and pump-

sets and for the development of land. Medium-term loans are also provided up to 75 per cent of the requirements for a period up to five years, and are repayable in half-yearly installments.

Many banks have also introduced schemes for financing custom service units, under which they finance the purchase of agricultural machines for hiring out, for harvesting, ploughing, threshing, lifting water and other farm operations.

(b) Credit to Small-Scale Industries : Small-scale industries get credit from banks for short periods or for medium terms on the basis of hypothecation of raw materials or semi-finished goods, or in the form of a charge on land, buildings, machinery, etc.

Finance provided to the small scale industries falls in two categories — (i) Direct finance provided to small scale industrial units and (ii) Indirect finance provided to small scale industrial units and (ii) Indirect finance to small scale industrial sector.

Direct finance : In the category of small scale industries are included :

- (i) artisans (irrespective of their location).
- (ii) cottage/village industries in village and small towns with a population not exceeding 50,000 involving utilisation of locally available natural resources and/or human skills where individual credit requirements do not exceed Rs. 25,000, and
- (iii) other small scale industries as defined in the previous chapter.

The small scale industrial units are those engaged in the manufacture, processing and preservation of goods and whose investment in plant and machinery (originally) does not exceed Rs. 3 crores. These units included those engaged in mining or quarrying, servicing and repairing of machinery in case of tiny sector the limit of investment of Rs. 25 lakhs,

Indirect finance to small scale industrial sector includes :

- (i) credit to agencies involved in assisting the decentralized sector in the supply of inputs and marketing of outputs of artisans, village and cottage industries.

- (ii) credit to Government-sponsored corporations/ organizations providing funds to the weaker sections in the priority sectors, and
- (iii) loans for setting up industrial estates.

(c) *Aritisans and Self-Employed Persons* : Artisans and self-employed persons also receive bank credit up to Rs. 3,000 for the purchase of machinery and raw materials on the guarantee of another person. For loan amounts exceeding Rs. 3,000, a bank may ask for the hypothecation of goods. Loans are to be repaid in installments extending up to 36 months. The borrower is required to take out a Life Insurance Policy for the amount of the loan, banks, moreover, have special schemes to provide complete finance for a project prepared by a qualified entrepreneur or craftsman for the manufacture of a product. Such schemes are meant for those who have no finance but who have technical knowledge and ability, and they are processed by the Small Industries Services Institute and certified technically feasible and economically viable. Financial assistance of Rs. 2 lakhs to Rs. 3 lakhs may be provided by a bank, depending upon the requirements of a project.

Transport Operators :

Banks also provide credit facilities for the purchase of a taxi or a scooter up to 75 per cent of the cost of the vehicle and for the purchase of a truck up to 70 per cent of its cost; the remaining part of the cost must be financed by the borrower. The vehicle will remain mortgaged to the bank till the loan is repaid, and its registration will be in the joint names of the bank and the borrower. In addition to a comprehensive insurance of the vehicle, the personal guarantee of a suitable person is required. The amount of the loan is to be repaid in 36 monthly installments. The interest charged by the bank is at the rate of 9 per cent for cars and scooters and 14 per cent for trucks.

A consolidated set of guidelines have been prepared by the Reserve Bank of India for priority sector lending. Reserve Bank also lays down targets for lending to the priority sectors as well as the weaker sections of the society. Important provisions of the guidelines are given below:

Guidelines

Margin Money :

For loans up to Rs. 25,000 no margin is to be maintained. In case of loans over Rs. 25,000, a margin of 15 to 25 per cent may be stipulated, depending on the purpose and quantum of loan. Where subsidy/margin money is available from Government and/or other agencies and is not less than 15% of loan, it should be considered sufficient margin.

The lower margins prescribed in respect of special schemes for technocrats *etc.*, may be continued. Margin may be introduced in stages as and when required. Bringing in such margin at the beginning of loan should not be insisted upon.

Security :

- (i) In case of composite loans up to Rs. 25,000 given to artisans, cottage and village industries banks may require as security pledge/ hypothecation mortgage of assets created out of the loans. Collateral security or third party guarantee should not be taken.
- (ii) The above is applicable to credit loans up to Rs. 25,000 given to other small-scale industries. For limits over Rs. 25,000 banks may obtain security as decided by them on the merits of each case.
- (iii) In case of advances over Rs. 25,000, collateral security or third party guarantee may be required only in cases where primary security is inadequate or for other valid reasons only (and not as a matter of routine).
- (iv) Viable proposals should not be turned down merely for want of such collateral security or third party guarantee.
- (v) Where feasible, equitable mortgage instead of registered mortgage should be taken.

Interest Rates should be charged as follows:

- | | | |
|----------------------------------|---|-----------------------|
| Composite loans up to Rs. 25,000 | — | 10% in backward areas |
| | — | 12% in other areas |

Short-term loans — not exceeding 14% for loans up to Rs. 2 lakhs
16.5% for loans over Rs. 2 lakhs and up to Rs. 25 lakhs
18% for loans above Rs. 25 lakhs

Term loans for not less than 3 years — 12.5% in backward areas
13.5% in other areas.

Banks should give finance to following categories of small units taking into account the following guidelines:

- (1) Credit limits up to Rs. 25,000 may normally be granted as composite term loans for purchase of machinery and equipment or working capital or both; alternatively they may be granted separately also.
- (2) Before granting composite term loans, banks should liberally assess the actual requirement of a borrower in a given period. Banks may grant 10 to 20 per cent additional credit also to meet any unexpected needs of funds due to operational difficulties or for some essential consumption needs.
- (3) At the end of every year, banks should review the sanctioned loans. The limits may be enhanced if the operation of the borrower has expanded or there has been increase in the costs.
- (4) Banks should not insist upon collateral security by way of immovable properties or third party guarantee as a matter of routine. Banks should be guided by the viability of projects. In fact banks have been asked to adopt a flexible approach towards margin requirement. A proposal, if otherwise in order, should not be rejected if the borrower is unable to provide margin money. In case of artisans and village industries no margin is to be insisted upon.
- (5) Composite term loans are repayable in 7 to 10 years, or even longer. Actual repayment of composite term loans and payment of interest should commence only after 18 months

from the date of loan disbursement. In case of borrowers who are already reasonably well established and who are expected to have sufficient viability to commence repayment earlier, this period is reduced to 21 months. The repayment schedule should be informed to the borrower at the time of grant of loans. The installment payments should not normally be more than one per cent of the loan amount per month.

General Consideration

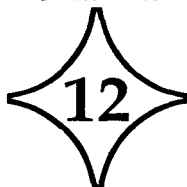
1. *Timely Sanction of Credit* : For all the borrowers in the small-scale industry, banks are expected to dispose of all loan applications up to Rs. 1 lakh within 30 days.

Branch managers of banks are given the discretion to sanction loans up to Rs. 25,000 without reference to any higher authority. Alternatively, suitable administrative machinery may be set up at the district level itself for this purpose. For advances above Rs. 25,000 and up to Rs. 1 lakh, the appraisal should be taken up simultaneously at both the District Industries Centers and the Bank. All loan proposals need not necessarily be routed through these centers.

2. Guarantee cover is available on advances granted to small-scale industries, as we have already studied in the previous chapter.

3. *Fire Insurance* : Bank may waive the requirement of insurance cover against fire risk for securities from small-scale industries for advances up to Rs. 25,000 in respect of composite term loans, term loans and working capital advances against non-hazardous goods. For other this limit is reduced to Rs. 10,000- This will not apply to those cases where insurance is compulsory under the compulsion of any law.

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OTHER BORROWERS IN PRIORITY SECTOR

Small Road and Water Transport Operators :

This type of borrowers includes operators of taxis, autorickshaws, cars, bullock-carts, other animal-driven carts, boats, barges, steamers and launches for carrying passengers or goods for hire. Those operators, who own not more than six vehicles, including the one which is proposed to be financed by the bank, can be given bank loans for the following purposes:

- (i) purchase of vehicles,
- (ii) acquisition of spares,
- (iii) periodical repairs of a major nature, and
- (iv) working capital purposes.

A banker must take the following precautions while giving loans to transport operators:

Precautions before Sanctioning a Loan :

- (1) The applicant for a loan must be properly introduced to the banker. The banker must try to know the background of the applicant, *i.e.*, his experience of driving the vehicle, his

honesty, character, *etc.* His driving license must be checked up to see whether it contains any endorsement regarding any accident. If the applicant has served as a driver with any employer, proper inquiry must be made with the latter about the formers conduct.

- (2) The banker should also ascertain the prospects of his proposed venture to know whether the applicant would be able to get enough business as a transporter. His estimated future profits should also be checked up to determine his loan repaying capacity within a stipulated period.
- (3) If the plying of vehicle, *e.g.*, truck, bus, *etc.*, requires a permit from a competent authority, the banker must ascertain if the same has been actually granted or assured to the applicant.
- (4) The applicant should furnish a guarantee from a reliable party well-known to the bank. If the banker's findings regarding (1) and (2) above are satisfactory, guarantee need not be insisted upon.

Precautions after Sanctioning a Loan :

- (1) The banker must directly make payment to the dealer in vehicles on the basis of Performa invoice, to ensure that the loan is properly utilized.
- (2) The vehicle to be purchased must be hypothecated to the bank and the interest of the bank in vehicle must be noted in the Registration Book and a certificate to this effect must be issued by the Regional Transport Office.
- (3) The banker must insist that the borrower takes a comprehensive insurance policy on the vehicle in the joint names of the borrower and the banker for its full value. The policy must continue till the entire amount of the loan is repaid.
- (4) The loan must be paid in three/four years in monthly/quarterly installments. The banker must ensure that the borrower pays the installments regularly.

- (5) The banker must obtain the following documents:
 - (i) a demand promissory note,
 - (ii) a letter stating that the demand promissory note be regarded as a continuing security for the outstanding amount of the loan,
 - (iii) an agreement of hypothecation,
 - (iv) a letter of guarantee, and
 - (v) a letter of loan.
- (6) Rate of interest on term loans for not less than 3 years is fixed at 12.5% for one vehicle and 15 per cent for two or more vehicles. The interest on short-term working capital is subject to a ceiling of 17.5%.

Retail Traders

Eligibility :

Retail traders in fertilizers are included in indirect finance for agriculture and retail traders in mineral oil under small business. Other retail traders are eligible to borrow under this category which includes advances granted to private traders dealing in essential goods (fair price shops) and consumer co-operative stores.

Purposes :

For acquisition of fixed assets and tools and other equipment's required for the trade.

Small Business

Eligibility :

Small business includes individuals and firms managing a business organisation which provide services (other than professional services). The original cost of their equipment's should not exceed Rs. 2 lakhs and the working capital limit should exceed Rs. 1 lakh. These services include cycle hire shops, booking, clearing and forwarding of goods, beauty parlours, juice vendors, laundress, mobile restaurants and publishers-cum-booksellers. Such units should be eligible for cover provided by DICGC.

Purposes :

For purchase of fixed assets and tools *etc.*

Professionals and Self-Employed Persons

This category includes loans granted to medical practitioners (including dentists), chartered accountants, cost accountants, lawyers or solicitors, engineers, architects, surveyors, construction contractors or management consultants or to a person who is trained in any other art or craft who holds a degree or diploma or to a person who is considered by the bank as technically qualified or skilled in his field. The borrowing limits of these persons should not exceed Rs. 2 lakhs of which not more than Rs. 1 lakh should be for working capital requirements. Such loans should be eligible for DICGC cover also.

Purposes :

- (i) For purchase of equipments, repairing or renovating of existing equipments, acquisition or repairing of business premises and purchase of tools, and
- (ii) for working capital requirements.

Students for Education Purpose**Eligibility :**

Students or their parents/guardians of minor students and not the educational institutions.

Purpose :

For pursuing graduate and post-graduate studies, professional courses or job-oriented diploma courses in India or higher education abroad.

State-Sponsored Bodies for Scheduled Castes and Tribes

Such lands should be granted for the specific purpose of purchase and supply of inputs and /or the marketing of the outputs of the beneficiaries of these organizations.

Housing Loans

(a) *Direct finance* includes loans up to Rs. 5,000 for construction of houses granted to Scheduled Castes/Tribes and the weaker sections of the society irrespective of DIGC cover.

(b) *Indirect finance* includes assistance given to any governmental agency for the purpose of constructing houses exclusively for the benefit of Scheduled Castes/Tribes and low income groups and where the loan component does not exceed Rs. 5,000 per unit, it also includes assistance to any governmental agency for slum clearance and rehabilitation of slum dwellers.

Realising the necessity to provide houses and improve housing facilities in the country, the commercial banks have been asked to provide fund for housing since 1979. Initially, they were expected to lend Rs. 150 crores annually, but the target was raised to Rs. 300 crores for the year 1989-90. For the year 1990-91 individual commercial bank's housing finance allocation was acquired to be computed at 1.5% of the incremental deposits on March 1990 over the corresponding figure of March 1989.

According to the guidelines issued by the Reserve Bank, bank's assistance to the housing sector (including rural areas) may be as follows :

- (a) 30 per cent of the total housing finance allocation by way of direct assistance to individuals or group of borrowers *etc.* out of which at least half should be given as direct housing loans in rural and semi-urban areas.
- (b) 30% of the allocation for lending to HUDCO, Housing Development Boards, HDFC and other housing agencies for construction of houses.
- (c) The remaining 40% of the assistance may be by way of subscription to the guaranteed bonds/debentures of HUDCO, and National Housing Bank.

The term and conditions *etc.*, for housing finance have been liberalised to encourage the flow of credit for housing as follows :

- (a) The loan can be used for purchase of a house or flat, construction of a house or tenement or for additions or extensions to an existing structure.

- (b) The loan will be secured by mortgage of the property. Banks also accept security of adequate value in the form of the insurance policies, Government promissory notes, shares and debentures or gold ornaments.
- (c) Term loans from banks to housing finance companies (other than HUDCO, HDFC and companies promoted by commercial banks) has been raised to three times their net owned funds in January, 1990.
- (d) The repayment period will be spread over 15 years.
- (e) The maximum amount of loan was earlier fixed at Rs. 3 lakhs per individual. But this ceiling was withdrawn effective 11th Oct. 1989.

Home Loan Account Scheme

This scheme is being launched with effect from July 1, 1989 by the National Housing Bank with the co-operation of commercial and co-operative banks to give housing loans to those who regularly deposit in this account for a period of 5 years. This Scheme has been launched by the National Housing Bank to mobilise savings through the banks. The participating bank is required to accept deposits under the Scheme on behalf of the National Housing Bank and make use of these deposits by way of refinance under any scheme approved by the National Housing Bank. The excess of deposits over refinance may either be remitted by the bank to the Housing Bank or may be retained by it, subject to compliance with statutory reserve requirements.

The money deposited in Home Loan Accounts, together with interest thereon at 10% per annum, are eligible for tax concessions under Section 80(c) of the Income Tax Act.

- (i) Any individual (including a minor) not owning a house anywhere in India can open a Home Loan Account. A coparceners of a Hindu undivided family jointly owning a house and Non-resident Indians can also open an account.
- (ii) The account may be opened with any branch in India of designated scheduled banks.

- (iii) The account-holder is expected to save regularly and deposit in the account in quarterly, half-yearly or annual installments, any amount subject to a minimum of Rs. 90, Rs. 180 or Rs. 360 respectively. The member may vary his contribution as and when it is convenient for him, but the contribution will be in multiples of 10.
- (iv) The saving will earn interest @ 10% per annum, which will be added to the account annually and treated as re-invested.
- (v) The account is not transferable to others. Nomination facility is available for payment of accumulated saving.
- (vi) After subscribing for a minimum period of 5 years, or any time thereafter, the member will be eligible for a loan from the bank to acquire a new house/flat. However, in the case of a minor, the loan will be admissible only after he attains majority. During this period of 5 years from the commencement of the Scheme the bank will give housing loans to members on a preferential basis on terms stipulated by the Reserve Bank. After 5 years, members will be permitted to withdraw the accumulated balance in the account for the purpose of acquiring a house/flat even if they do not avail of the loan facility.
- (vii) After 5 years, the amount of loan to be given by the bank under the Scheme will be a multiple of the amount of accumulated savings (including up-to-date interest). It will be 4 times the accumulated savings. If the built in accommodations is up to 430 sq.ft. :3 times if such accommodation is up to 860 sq. ft. and twice the accumulated savings in all other cases.

The amount of loan will, however, be limited to the repaying capacity of the beneficiary as assessed by the bank. The loan will normally not exceed 2½ times the annual income. The maximum amount of the loan will be Rs. 3 lakhs.

The borrower under the scheme may avail of loan facilities from other sources also, including a loan from a bank on usual terms. The loan under the scheme will be subject to all other

conditions laid down by the Reserve Bank for grant of housing loans by banks. Loan under this scheme will be an additional facility with assurance loan at a lower rate of interest.

Consumption Loans

Eligibility :

Small and marginal farmers with land-holdings up to two hectares, landless labourers, rural artisans and other people of very small means, like carpenters, barbers and washer-men.

The scheme to give consumption loans to the poorer sections of the society has been in operation since 1976. Recently the scheme has been liberalised as follows :

(a) *Eligibility* : The scheme is now applicable to all the weaker sections of the society. "Weaker sections" means all IRDP beneficiaries, small and marginal farmers, landless agricultural workers, rural artisans and other people of very small means like carpenters, barbers and washer-men.

(b) *Purposes and Ceilings for Loans* : Loans may be granted for the following purposes within the ceilings prescribed per family.

(1) General consumption	Rs. 150
(2) Medical expenses	Rs. 500
(3) Educational needs	Rs. 200
(4) Marriage ceremonies	Rs. 500
(5) Funerals, births etc,	Rs. 150
(6) Certain religious ceremonies	Rs. 150

The aggregate advance for 2 or more purposes should not exceed in cases where the loans are granted against the security of gold and silver ornaments. In such cases the ceiling limits has been enhanced to Rs. 2,000 per family.

Guidelines :

Margin Money : No margin is needed in case of loans up to Rs. 25,000. For loans exceeding Rs. 25,000 a margin of 15 to 25 per cent

may be maintained depending on the purpose and amount of loan. The margin for housing loans up to Rs. 5,000 to Scheduled Castes/ Tribes and weaker section is 20 per cent of the cost of construction. Where labour is contributed by the borrower himself, contribution in the form of labour could be taken as margin. Where subsidy/ margin money is available and is not less than 15% of loan amount no further margin should be maintained.

Security :

- (i) For loans up to Rs. 25,000 pledge/hypothecation/ mortgage of assets created out of loan is sufficient security. (Banks should not ask for collateral security or third party guarantee.)
- (ii) In case of loans exceeding Rs. 25,000, the security to be taken may be determined by banks on the merits of each case. Collateral security or third party guarantee may be required only in cases where primary security is inadequate or for other valid reasons.
- (iii) Mortgage of properties or government guarantee is sufficient for housing loans.
- (iv) Guarantee of one or more individuals or groups of persons may be obtained for consumption loans.
- (v) Proposals otherwise viable should not be turned down merely for want of collateral security or third party guarantee.
- (vi) Wherever feasible equitable mortgage instead of registered mortgage should be taken to save stamp duty.
- (vii) In case of clean loans for education, guarantee or collateral security may be taken on the merits of each case.

Interest Rates :

Interest is to be charged as follows:

- (i) *Retail traders for distribution of fertilizer* : 11.5 % for limits up to Rs. 5,000 not exceeding 14% for limits over Rs. 5,000 and up to Rs. 25,000, not exceeding 16.5 % for limits over Rs. 25,000;

(ii) *Other retail traders* : 12.5% for loans up to Rs. 5,000, not exceeding 15% for loans up to Rs. 5,000, not exceeding 15% for loans over Rs. 5,000 and up to Rs. 25,000;

(iii) *Professionals and self-employed persons belonging to SC/ST and women entrepreneurs*: 14 per cent for loans other than term loans, 13.5 per cent for term loans;

(iv) *Education* : Not less than Bank rate for advances to indignant students for purpose of higher education in India and 14-16.5 per cent for other educational advances;

(v) *Housing* : 4 per cent for loans to SC/ST up to Rs. 5,000;

(vi) *Road Transport operators* : 12.5 per cent for up to 2 vehicles and 15 per cent for more than 2 vehicles:

(vii) *Priority Sectors not otherwise specified* : Not exceeding 16.5 per cent for short-term loans, 15 per cent for all term loans.

Integrated Rural Development (IRDP) :

Integrated Rural Development Programme (IRDP) envisages capital subsidy and credit assistance generating assets to come up above the poverty line. The total term credit disbursed during 1991-92 by the banks was Rs. 1133.27 crore to 25.27 lakh beneficiaries.

Self Employment Programme for Urban Poor (SEPUP) :

The programme was launched by Govt. of India on 1st Sept., 1986 with the objective of encouraging families living below subsistence level in metropolitan, urban and semi-urban areas to undertake self-employment venture with the help of subsidy and bank credit. The programme covers cities and towns having population exceeding 10,000 as per 1981 census and all urban areas administered by municipal committees/town area committees notified area councils which are covered under IRDP, irrespective of their population.

In the scheme, assistance up to Rs. 5,000 depending on unit cost is admissible to an eligible beneficiary for undertaking any of the eligible vocations. The borrowers are eligible for a capital subsidy of 25 per cent of the total amount of assistance. Applicant should

have lived at least for three years in the city/town area. The family income of the beneficiaries should not have exceeded Rs. 600 per month.

During 1991-92, an amount of Rs. 48.86 crore was sanctioned to 1.11 lakh beneficiaries. The Self Employment Programme for Urban Poor (SEPUP) was merged with the Scheme for Urban Micro Enterprises (SUME) under the Nehru Rozgar Yojna (NRY) with effect from 1st April, 1992.

Scheme of Urban Micro-Enterprises (SUME) :

The Scheme of Urban Micro Enterprises (SUME) was introduced on 15th June, 1990 with the objective of giving employment to the unemployed and under-employed poor in urban areas. It covers unemployed urban poor living below the poverty line with an annual family income of Rs. 11,850 and below for the Eighth Five-Year Plan with effect from 1st of April, 1992 in metropolitan areas, cities and towns not covered by IRDP. The urban local bodies are primarily responsible for identifying beneficiaries. Maximum loan amount presently permitted is Rs. 15,000 in case of SC/ST and women beneficiaries and Rs 4,000 for others. The subsidy is routed through the urban local bodies.

Prime Minister's Rozgar Yojna

This scheme was introduced on October 2, 1993 with the objective to give sustained self-employment in micro enterprises to educated unemployed rural and urban youth. The salient features of the scheme are as follows:

- (i) The youth should be in the age group of 18 and 35 years and his family income should be less than Rs. 24,000 per annum.
- (ii) The beneficiary would bring in 5% of the project cost as margin money.
- (iii) He will be entitled to a composite loan up to Rs. 1 lakh without a collateral security or guarantee and also a Government subsidy of 15% subject to a ceiling of Rs. 7,500.

- (iv) Applicants who have formed a partnership concern are also eligible for loan/subsidy to each borrower does not exceed the prescribed ceiling. Total cost of the project should not exceed Rs. 5 lakh. Cooperative are not eligible for assistance.
- (v) The rate of interest on loans granted under the scheme will be guided by Reserve Bank's directive.
- (vi) The subsidy will be sent to the disbarring bank in advance and it will be treated as fixed deposit in the name of the beneficiary.
- (vii) The beneficiary will be required to hypothecate/mortgage/pledge assets created out of the loan to the bank.
- (viii) If no fixed assets are to be created from the loans above Rs. 50,000 banks should take extra care in scrutinizing the case.

From April 1994, the earlier self employment scheme for educated unemployed youth (SEEDY) was included in this scheme.

Prime Minister's Integrated Urban Poverty Eradication Programme (PMIUPEP)

This scheme was introduced in January 1996. It has two components (a) Self Employment Scheme (SES) and (b) Shelter Upgradation Scheme (SUS). The Scheme aims at eradicating poverty in targeted Urban areas in an integrated manner and is being implemented in over 400 urban areas. Its important features are as follows :

- (i) Urban poor including slums/pavement dwellers and street/destitute children *etc.*, whose household income is below Rs. 11,850 per annum and who are educated up to IX standard are eligible for assistance under the scheme.
- (ii) Under Self Employment Scheme (SES) :
 - (a) Projects up to Rs. 1 lakh would be financed.
 - (b) 5% of the project cost would be the margin money to be brought in by the borrower.

- (c) Balance 95% would be provided as loan.
 - (d) The loan would be repayable in installments spread over 3 to 7 years, after an initial moratorium of 6 to 18 months no collateral is required under this scheme.
- (iii) Under the Shelter Upgradation Scheme (SUS) —
- (a) 75% of the unit/renovation/repair cost (subject to a ceiling of Rs. 10,000 per household) would be financed.
 - (b) Remaining 25% (subject to a ceiling of Rs. 2,500) would be provided as subsidy.
 - (c) The repayment would be spread over 10 years.
 - (d) Appropriate guarantees required for loans under this scheme.

The applications for assistance under this scheme are to be forwarded by the Urban Local bodies, which should satisfy themselves of the applicant's status and enclose a certificate to that effect with the application.

Common Guidelines

The following are the common guidelines applicable to all the advances in the priority sector:

(1) **Loan Disbursement** : As far as possible loan amounts should be disbursed directly to the suppliers of seeds, fertilizers, raw materials, implements, trucks, machinery, etc.

(2) **Re-payment Schedule** : The schedule for the repayment of the loan should be filed on the basis of the following factors, viz.:

- (a) sustenance requirements of the borrower,
- (b) surplus generating capacity,
- (c) break-even point,
- (d) life of assets, etc.

In respect of composite loans up to Rs. 25,000 to artisans, village and cottage industries, the repayment schedule may be fixed for term loan component only.

In case of default on account of national calamities like floods and drought, crop loans may be converted into medium-term loans of 3 to 5 years. In case of term loans extension or replacement may be allowed.

Similarly in case of borrowers affected by natural calamities, draws exceeding the value of security may be converted into a term loan repayable over a reasonable period of time. Further working capital may be extended or rephrased.

(3) **Guarantee Premium** : Banks should themselves bear the premium payable to DICGC in respect of the following advances:

- (i) advances to weaker sections,
- (ii) housing loans up to Rs. 5,000 to Scheduled Castes/Tribes and weaker sections, and
- (iii) pure consumption loans.

In other cases the amount of premium may be passed on to the borrowers, but interest and premium together should not exceed 18 per cent.

(4) **Penal Interest** : No penal interest should be charged for loans up to Rs. 25,000. For others it may vary from 1 to 2.5 per cent over the normal rates of interest.

(5) **Inspection Charges** should be as follows:

- (i) advances up to Rs. 5,000 nil
- (ii) advances above Rs. 5,000 but Rs. 2.50 per inspection per up to Rs. 25,000 borrower with a maximum of Rs. 10 per year per borrower.
- (iii) advances above Rs. 25,000 Reasonable charges.

(6) **Insurance Cover** : Where finance is given for purchase of equipment and the credit facility covered under DICGC guarantee scheme does not exceed Rs. 10,000, requirement of insurance against fire may be waived. For other risks it may be waived for advances up to Rs. 5,000 covered by DICGC schemes.

Insurance cover against fire risk may be waived for securities taken for advances up to Rs. 25,000 granted to small-scale industries

and covered under DICGC guarantee in respect of composite loans to artisans, village and cottage industries *etc.*, term loans and working capital advances against non-hazardous goods. In other cases, the insurance cover may be waived to the extent of Rs. 10,000 for SSI advances covered under DICGC guarantee. But where insurance vehicle, machinery or other equipment is compulsory under the provisions of any law, it should be waived in any case.

(7) *Borrower's Photographs* may be taken for purpose of identification. Banks should make arrangement for the same and also bear the cost in respect of weaker section borrowers.

(8) *Other Charges* : Only reasonable out of pocket expenses should be recovered from the borrower.

(9) *Loan Pass Books* in regional languages should be issued to all IRDP beneficiaries giving necessary details of the loan.

(10) *Disposal of Applications* : Applications for credit limit up to Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000 within 8 to 9 weeks. The case rejected by the Branch Manager should be verified subsequently by the divisional regional managers.

Special Credit Schemes

Some Commercial banks have formulated Special Credit Schemes with particular reference to employment potential. Banks should take into account the following points while granting advances:

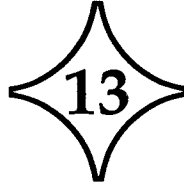
- (a) The credit given by commercial banks should be sufficient to meet the total requirements of borrowers. The loan may be utilized for meeting the legitimate expenses for renovation of equipment, acquisition of spares and periodical repairs of major nature. Advances may also be granted for purposes like advertising and marketing surveys.
- (b) Reasonable amounts should also be granted for meeting expenses for family maintenance in case of persons who

commence business/ practice and those who leave well-established jobs to take up self-employment.

- (c) The banker should lay primary emphasis on the viability of the proposal. An applicant's skill, experience, integrity and ability to organize an activity or a business are also taken into account.
- (d) Loans up to Rs. 500 are disbursed on the basis of demand promissory notes or simple loan agreement.
- (e) If third party guarantee is not available and the quality of the proposal is otherwise satisfactory, loan should not be denied.
- (f) Banks should help the borrowers in obtaining technical advice and guidance.

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CHAPTER



GUARANTEE OF LOANS FOR SMALL-SCALE INDUSTRIES

The Seminar on the Financing of Small-scale Industries organized by the Reserve Bank of India in July 1969 had come to the conclusion that bank lending to small business might be enlarged by enabling them to share the risks involved with some other agency set up especially for this purpose. Accordingly, the Government of India, in consultation with the Reserve Bank of India, prepared a Guarantee Scheme, the object of which was to enlarge the supply of institutional credit to small-scale industrial organisations by granting a degree of protection to the lending institutions against possible losses in respect of such advances. The scheme was administered by the Reserve Bank of India as an agent of the Government of India. A working group was set up in 1969 by the Reserve Bank to evaluate the scheme, which was amended in 1970 in accordance with the recommendations of the working group.

Credit Guarantee Schemes

The Deposit Insurance and Credit Guarantee Corporation (DICGC) has been empowered to guarantee credit facilities granted by any credit institution and to indemnify them in respect of such

credit facilities. The term 'credit institution' has been defined so as to include commercial banks, including the nationalised banks, the Regional Rural Banks, the Co-operative Banks and the financial institutions as defined in Sec. 45(1) of the Reserve Bank of India Act 1934. The term 'Credit Facility' has been defined so as to include any financial assistance, including a loan or installment credit and any guarantee other than a performance guarantee granted or issued in India by a credit institution at any of its offices in India." Like banks the DICGC is also under a statutory obligation to maintain secrecy about any information relating to an incurred bank or its customers or a credit institution and its customers, except in circumstances in which it is in accordance with law or practice or us ages customary among bankers, necessary or appropriate for the Corporation to divulge such information.

The DICGC at present administers the following three Credit Guarantee Schemes :

- (i) The Small Loans Guarantee Scheme, 1974
- (ii) The Small Loans (Small Scale Industries) Guarantee Scheme, 1981.

Guarantee Fee :

The corporation charged a graduated scale of guarantee fee, which are weighted in favour of small borrowers till March 31, 1989. With effect from April 1, 1989 the rate of guarantee fee was enhanced to 1.5 per cent per annum uniformly. It is now payable in advance on an annual basis and is to be calculated on the amount of a bank's priority sector advances (less advances to small scale industries), outstanding at the end of March every year as reported in the Annual Report. The fee may be paid on *ad hoc* or final basis by April 30 every year. In case of *ad hoc* payment, final payment may be made by July 31 with interest at Bank rate on the amount of shortfall. If payment is made after July 31, interest rate will be 2% above the Bank rate.

Guarantee Cover :

In respect of credit facilities granted/renewed/alterd on or after 1st January 1985, the guarantee covers 60% of the amount in

default under all the schemes of the Corporation. On loans granted prior to January 1, 1985 the guarantee cover continues up to 75% of the amount of default.

All renewals or enhancements of credit limits given to borrowers are treated by the Corporation as fresh credit facilities granted. This step has been taken to avoid dilution in the quality of lending to small borrowers.

Monetary Ceiling on Corporation's Claim Liability :

Within the cover of guarantee, which is now 60% of the amount in default, in case of all types of borrowers at DICGC has laid down certain monetary ceilings on its claim liability which have been enhanced from April 1, 1989 as follows :

(i) Transport operators	Rs.	1,50,000
(ii) Retail Traders	Rs.	25,000
(iii) Farmers & Agriculturists	Rs.	60,000
(iv) (a) Crop Loans	Rs.	10,000
(b) Development Activities	Rs.	20,000
(c) Conversion Loans	Rs.	30,000
(iv) Professional & Self-employed persons	Rs.	50,000
(v) Indirect Finance for Agriculture	Rs.	60,000
(vi) Housing — Indirect Finance	Rs.	60,000

The amount in default means an amount on account of any eligible credit facility, including interest and any other charge, which:

- (a) has become due and payable to the bank but has not been paid after the expiry of a period of one month from the date on which a notice of demand was served by the bank, and
- (b) has been treated as bad or doubtful of recovery and has been provided or accounted for as such in the books of the bank. It is therefore, essential that a claim must be supported by such entries passed in the books of the bank.

If the external auditor of the banks does not consider the dues as bad or doubtful, the bank should immediately refund to the Corporation any amount received by it towards the claim.

Invocation of Guarantee :

Till March 31, 1989 banks were allowed to invoke the guarantee if the repayment was not made by the borrower on demand by the banker. But from April 1, 1989 the Corporation introduced a lock-in period of 3 years from the date of advance for the invocation of guarantee. It meant that banks were not allowed to file their claims within a period of three years from the date of the advance.

On the payment of a claim, the corporation shall be deemed to have been discharged from all its liabilities on account of the guarantee. But the Corporation subrogated to the rights of the bank. If the bank subsequently recovers any amount from the borrower, it should be shared, after deducting expenses, if any, between the Corporation and the bank. Corporation's share of such amount must be paid within one month. Thereafter, interest at the Bank Rate shall be charged.

If no further recoveries are possible the balance in the borrower's account may be written off after obtaining the Corporation's approval.

Guidelines for the Bankers :

The Guarantee Scheme also some certain provisions for the guidance of the bankers so that they do not resort to any indiscriminate lending merely because of the availability of the guarantee cover from the Corporation. These provisions are not mandatory and if the banker considers it necessary, he may relax any of these provisions in a particular case or may even grant an unsecured loan. The guarantee shall not be conditional on the observance or enforcement of any of following provisions :

- (a) Banks are expected to satisfy themselves about the integrity of the borrower and the genuineness of his requirements.
- (b) The project or purpose should be productive or socially useful and should yield a surplus from which the loan can be repaid.
- (c) Normally, a bank is expected to obtain any security which may be available such as goods or other assets, a life insurance policy or other collateral security, the guarantee

of the third party or even a group guarantee under which small security is taken the bank may prescribe somewhat lower margins than usual.

- (d) Clean loans and facilities can be granted and covered under the scheme, but only when no security can be offered by the borrowers.
- (e) The bank should improve the security in respect of any facility, which may be granted, wholly or in part as clean or un-secured if and when the borrower becomes subsequently able to furnish any acceptable security covering the full amount of the facility.
- (f) The bank is expected to obtain as a rule a charge on the goods or other assets created out of the loan or other credit facility granted by it and on any other goods or assets available with the borrower.
- (g) The bank should take the necessary follow-up action to ensure that the loans are actually utilized for the purposes for which they are sanctioned.

Credit Guarantee Corporation of India, Small Loans (Guarantee) Scheme, 1971 :

After the nationalization of commercial banks, there was an enormous increase in the credit to small borrowers, which necessitated some guarantee scheme for bankers to help them and facilitate their lendings to such borrowers. A working group was set up by the Government of India under the chairmanship of Mr. S.S. Shiralkar, which submitted its recommendations in 1969. On the basis of these recommendations, the Credit Guarantee Corporation of India Limited was established on January 14, 1971, as a limited company under the Indian Companies Act. Its authorized capital is Rs. 10 crores and paid-up capital Rs. 3 crores. The Reserve Bank of India holds 60 per cent of the capital, the balance being contributed by scheduled banks in the public and private sectors. The Credit Guarantee Corporation of India introduced a comprehensive guarantee scheme from April 1, 1971. Under this scheme, all the credit facilities given by banks to small

traders, transport operators, traders in fertilizers and other goods, professionals and self-employed persons and farmers are covered by a guarantee of the Corporation.

Scope of the Guarantee Scheme :

All commercial banks are eligible for participation in the guarantee scheme after the execution of an agreement with the Corporation. The credit facility covered by the guarantee means any financial assistance, including a loan or an advance, cash credit, overdraft, bill purchased or discounted, a term installment credit, a letter of credit or acceptance credit and any guarantee (other than a performance guarantee) granted by banks in India.

The following types of credit extended by banks shall not be covered by the guarantee scheme:

- (a) Credit in respect of which risk is already covered by the Government or any general insurer;
- (b) Any credit facility which is inconsistent with the provisions of any law or with any directive of the Reserve Bank;
- (c) Any credit facility in respect of which the guarantee was extended previously and the borrower has not paid back any part of the loan guaranteed;
- (d) Any credit facility granted to hire purchase financiers or to proprietors or publishers of newspaper and periodicals.

In the case of credit granted in the guarantee scheme, the liability of the Corporation to reimburse the banks is up to 75 per cent of the amounts of default. The remaining 25 per cent is to be borne by the Banks themselves. The fees charged by the Corporation is 1/2 per cent on the amounts outstanding on account of credit facilities, is payable quarterly, and is calculated on the total balances in individual accounts during the previous quarters.

Special Provisions in Relation to Credit Facilities to Borrowers in Various Sectors :

Till March 31, 1989, the scheme contained special provisions in relation to credit facilities to borrowers covered under the Scheme. These provisions were classified into two categories : (i) essential for being eligible, and (ii) desirable.

For Transport Operators :

Essential : Transport operator must be an individual or an association of not more than six individuals owning and normally operating by himself, or themselves, a transport vehicle for carrying any passengers or goods for hire. The eligible borrowers will be those who own and operate not more than one vehicle. Loan sanctioned for (i) meeting the cost of the vehicle of purchase, or (ii) for repairing or renovating the vehicle, (iii) for working requirement are covered by the guarantee.

Desirable : The bank's interest as the financier should be recorded on the registration certificate and a comprehensive insurance policy be taken out by the transport operator with a clause assigning hi favour of the bank such rights as do not belong or accrue to third parties under the policy operator must pay regularly taxes and other duties and keep the vehicle in reasonably good repair. The period of repayment of the loan should be 3-5 years which may be extended if necessary.

Retail Traders :

Essential: The trader must be an individual or group of individuals, firm or registered co-operative society, trading in goods and should not have an annual sales turnover of more than Rs. 4 lakhs.

Desirable : The loan is allowed only against merchandise which are readily saleable or against bills or book debts representing amounts receivable by the borrower on account of the sale of merchandise. Statements of stock-in-trade or the value of stocks are obtained from the borrower and the drawing power regulated according to the margin prescribed in the account.

For Dealers in Fertilizers and Mineral Oils :

The dealer must be an individual, firm or a registered co-operative society trading in fertilizers or mineral oils and should not have an annual turnover of more than Rs. 5 lakhs. The duration of the loan should not exceed 5 months in the case of a dealer who is not a co-operative society and 6 months if the dealer is a co-operative society.

For Professionals and Self-Employed Persons :

Professionals and self-employed persons include:

- (a) Medical Practitioner;
- (b) Dentists;
- (c) Chartered Accountants;
- (d) Cost Accountants;
- (e) Lawyers;
- (f) Solicitors;
- (g) Engineers;
- (h) Architects;
- (i) Surveyors;
- (j) Construction Contractors;
- (k) Management Consultants.

They may also be such other persons as are trained in other arts or crafts, who hold a degree or diploma or otherwise are technically qualified or skilled. The amount of the loan or other credit facility should not exceed Rs. 1 lakh in the case of a doctor having a dispensary, or a nursing home or a clinic and for construction contractors; Rs. 50,000 in the case of engineering consultants and architects; and Rs. 20,000 in the case of other professionals and self-employed persons.

Small Business Enterprises:

Essential : The business enterprise has been or is established by an individual or a firm and the original cost price of the equipment used for the purpose of the business should not exceed Rs. 2 lakhs. The loan must be utilized for purchasing the equipment or for carrying on the business of the concern, which must render any services, other than professional services.

Desirable: The income from rendering the services or from any other sources regularly brought to account and recorded in the books of the borrower. Proper books of account must be maintained by the borrower. The current assets of the enterprise are reasonable by the borrower must be actually recovered within a reasonable period.

For Farmer and Agriculturists :***Essential :***

- (i) The borrower may be an individual or Hindu undivided family or any group or association of persons, other than a company or a cooperative society. He may be the owner, tenant or lessee (including an oral lessee) of any land for agricultural or allied activities, like pisciculture, sericulture, animal husbandry, poultry farming, dairy farming *etc.*
- (ii) In case a loan is granted to a group or association of persons, every member of the group or association must be jointly or severally responsible to the bank for the entire amount of the loan.
- (iii) The period of repayment should not exceed 24 months from the date on which it is first utilized in case it is sanctioned for financing sugarcane. 15 months for seasonal agricultural operations and 15 years for any other purpose.

Precautions :***The Bank should as far as Practicable, Ensure the Following :***

(a) The borrower is able to furnish satisfactory evidence to the bank that he is actually engaged in the cultivation of land, which bears a specified survey number or is otherwise identifiable or in any other activity for financing which the loan is granted.

(b) The land, farm, establishment or other business premises of the borrower can be visited or inspected. It must be located in a compact and contiguous area in which other borrowers have also been granted credit facilities or in area which is accessible to the bank and the Corporation.

(c) In case of credit facility for financing seasonal agricultural operations, the facility is utilized mainly for meeting through the bank or through sources known to or identifiable by the bank, the cost of fertilizers, pesticides, seeds or other agricultural inputs.

(d) In the case of credit facility for financing the reclamation and improvement of land, the construction of irrigation wells, the installation of pump sets for drawing water, the purchase of machinery or equipment or the acquisition of any other capital

assets, satisfactory evidence is furnished to the bank to the effect that the facility has been actually so utilized.

(e) The borrower avails himself technical assistance or other facilities available from any agency established in his area in connection with the utilisation of the facility.

Credit Guarantee Scheme for Loans Granted by State Financial Corporations :

Credit facilities provided by State Financial Corporations have also been eligible for guarantee from 1st July, 1971, under a new scheme formulated by the Credit Guarantee Corporation of India Ltd., known as the Credit Guarantee Corporation of India Small Loans (Financial Corporations) Guarantee Scheme, 1971. This scheme is similar to that applicable to commercial banks.

Credit Guarantee for Small-scale Industries :

The credit facilities provided by State Financial Corporations are already covered under the Credit Guarantee Scheme for small-scale industries, which is administered by the Industrial Finance Department of the Reserve Bank of India on behalf of the Central Government. This scheme was introduced in July 1960 to enlarge the flow of institutional credit to small-scale industries. It covers credit granted to small-scale units whose investment in plant and machinery does not exceed Rs. 7.5 lakhs. The Guarantee Corporation charges a fee at one-tenth of 1 per cent per annum on a quarterly basis. The Guarantee Corporation shall pay 75 per cent of the amount in default or the amount guaranteed. Credit facilities granted to small-scale industrial concerns engaged in the following activities alone are eligible for guarantee under this scheme: (a) manufacture, (b) processing, (c) preservation of goods, (d) mining and quarrying, (e) servicing and repairing of certain types of machinery, and (f) customer service units.

As the State Financial Corporations are prevented by law from assisting any concern other than certain specified industrial firms as defined in the State Financial Corporation Act, 1951, the scope of its new scheme is limited to the residual categories of small borrowers, who include transport operators, hoteliers and small

entrepreneurs engaged in generating or distributing power or in developing and managing industrial estates.

Small Loans (Small Scale Industries) Guarantee Scheme, 1981

The corporation operates this scheme since April, 1981 in respect of advances granted to small scale industrial units. Certain liberalization's and other changes have been effected in the scheme with effect from April 1, 1989. The salient features of the Scheme, as in force at present, are as follows:

1. Eligible Institutions : Commercial Banks, Regional Rural Banks, State Financial Corporations, certain Co-operative banks and Industrial Development Corporations, which provide loans to small scale industries are eligible for guarantee cover.

2. Eligible Borrowers : Originally the small scale industrial units were the eligible borrowers under the scheme. With effect from April 1, 1989 the 'priority sector' definition of Reserve Bank has been adopted for the purpose of extending the guarantee. Hence indirect finance to small-scale sector and credit facilities to industrial estates have also become eligible for guarantee cover under the scheme. Thus, at present, the following borrowers are eligible for guarantee cover under the scheme.

(i) *Small Scale Industries :* Small Scale Industrial units are those units which are engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery (original cost) does not exceed Rs. 3 crores. These units also include units engaged in mining, quarrying, servicing and repairing of machinery. If an industrial unit acquires plant and machinery of the total original cost exceeding the above limits, it cannot qualify as a small scale industrial unit. Service-oriented enterprises having investment in plant and machinery not exceeding Rs. 2 lakhs each and located in rural areas and towns with a population of 5 lakhs or below are also eligible borrowers under the scheme. Such establishments provide personal or household services required in urban, semi urban/rural areas such as laundry, xeroxing repair and main tenancy of durables, etc.

(ii) *Indirect finance to Small Scale Industrial Sector* will include credit granted to :

- (a) Agencies which assist the decentralised sector in the supply of inputs and marketing of outputs of artisans, village and cottage industries, and
- (b) Government-sponsored corporation/organisation which provide funds to the weaker sections in the priority sector.

(iii) *Industrial Estates* : Loans granted for setting up industrial estates are now also eligible for guarantee cover under the scheme.

3. **Compulsory Coverage** : Till April 1, 1989, participation in the guarantee scheme by the eligible institutions was voluntary and they were required to enter into an agreement with DICGC for joining the scheme. Thereafter all of their eligible loans were automatically covered.

Now, the guarantee fee shall be payable on the entire priority sector advances as reported in the Annual Report of the banks. It implies that guarantee cover shall be applicable to all the priority sector advances of the eligible institutions.

4. **Eligible purpose and Credit facilities** : Loans granted for both of the following purposes are eligible for guarantee cover :

- (i) For acquiring fixed assets and equipment such as land, building machinery, furniture, and vehicles, and for their repairs and replacement, and
- (ii) For the purpose of working capital, *e.g.*, for production and marketing of products.

The banks are required to ensure that these loans are used only for genuine productive purposes and to examine the financial viability of the project and the integrity of the borrower. The guarantee cover is not required in the case of the following :

- (i) Performance guarantees.
- (ii) Loans which are already covered under any guarantee given by the Government or general insurer or any person or association carrying on the business of insurance, guarantee and indemnity.
- (iii) Credit facilities which do not conform to the provisions of any law of directives or instructions.

5. *Extent of Guarantee Cover* : DICGC gives guarantee cover on graduated scale. The extent of such cover as percentage of the amount in default is as follows :

- | | |
|--|---|
| (a) Small Scale Industrial Units having total credit facilities not exceeding Rs. 2 lakhs | 60% |
| (b) Small Scale Industrial Units having total credit facilities exceeding Rs. 2 lakhs in- | |
| (i) Backward district specified by Government and other areas as may be specified by Government of India and DICGC | 60% |
| (ii) Other Areas | 50% |
| (c) Agencies assisting the decentralized sector and Government sponsored corporations or organizations | 60% in respect of Credit facilities up to Rs. 2 lakhs per borrowing unit. 50% in other cases. |
| (d) Loans for construction and running of Cold Storage/Loans to Custom Service units/Industrial Estates | 60% or 50% as stated above |

The ceiling on claim liability per borrower has increased from Rs. 10 lakhs to Rs. 20 lakhs per borrowing constituted, which is equally and separately divided between term loans (Rs. 10 lakhs) and working capital loans (Rs. 10 lakhs). In respect of (c) above the monetary ceiling is Rs. 60,000 only per borrower. The higher ceiling limit shall be applicable to credit facilities granted on or after April 1, 1989. The maximum amount that can be claimed per borrower by all the financial institutions together has been fixed as above. If the total claims of all the financial institutions providing loans to a borrower exceed this limit, he shall have to share the maximum amount payable under the scheme on a pro rata basis.

6. *Guarantee Fee* : Till March 31, 1989 the DICGC charged a guarantee fee from the credit institutions at the following rates:

- (i) 0.5% per annum on the amount outstanding in case of borrowers having eligible credit facilities up to Rs. 25,000, and
- (ii) 0.75% in case of other borrowers.

The guarantee fee was payable in two half-yearly installments (April-September and October-March). The fee was calculated with reference to the balance outstanding in the individual guaranteed accounts as on the last Friday of the preceding half-year. The rate of guarantee fee has been raised to 1.5 per cent per annum uniformly with effect from April 1, 1989 and is payable in advance on an annual basis (instead of on half yearly basis). It is to be calculated on the amount of credit institution's priority sector advances (less advances to non-SSI sectors) outstanding as at the end of March every year. Guarantee fee is payable on *ad hoc* or final basis by April 30 every year. In case *ad hoc* payment is made by April 30, final payment must be paid by July 31, together with interest at Bank rate on the amount of short fall. If payment is made after July 31, the rate of interest will be 2% above the Bank rate.

7. Invoking of Guarantee : Till March 31, 1989 a credit institution was permitted to invoke the guarantee if it fails to recover from the borrower the loan amount within one month from the date of issue of demand notice and if it treated the dues as bad and doubtful of recovery. But with effect from April 1, 1989, the lock-in-period of 3 years from the date of advances for invocation of guarantee has been discontinued in April 1995 and rules as in the 1971 scheme were enforced.

8. Precautions :

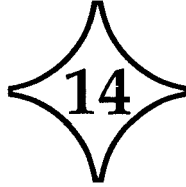
(a) The credit institution should not have suffered any loss in respect of the loan due to the :

- (i) negligence of its employees in the observance of necessary safeguards in the appraisal, supervision and follow-up of credit facility.
- (ii) any dishonesty on their- part; or
- (iii) decisions taken by them which are contrary to or in contravention of the instruction by their own institution or the guidelines advised by DICGC.

(b) The credit institution should take effective steps against the borrowers, and the sureties. The securities available should be realised* for whatever amount is possible. Guarantee should, thereafter, be invoked for the rest of the amount.



CHAPTER



CREDIT GUARANTEE FOR SERVICE CO-OPERATIVES

From 1st October, 1971, the Credit Guarantee Corporation of India Ltd., has started guaranteeing loans and other credit facilities to service co-operative societies, which may be serving small-scale industrial organisations. Co-operative societies which are not themselves engaged in any manufacturing, processing or other industrial activity, but help their members in carrying on such activity by arranging the purchase and supply of raw materials, display and marketing of finished goods, procurement of orders and sale of finished goods, are eligible under this scheme.

Differential Interest Rates :

For a long time, it was felt that lower interest rates should be charged from some sectors of the economy which need financial assistance but cannot get it from banks because of higher interest rates. The Reserve Bank of India appointed a committee under the chairmanship of Dr. R.K. Hazari to examine the question of differential interest rates. The terms of reference of the committee were:

- (i) To review the scope and extent to which differential interest

rates were already being charged by banks from borrowers in each sector;

- (ii) To determine the criteria for identifying the borrowers who may be granted the benefit of lower interest rates in each sector;
- (iii) To indicate the range of the differential rates that may be allowed in each sector; and
- (iv) To examine if any other concessions should be granted either in lieu of or in addition to, lower interest rates.

On the recommendations of this committee which submitted its report in *May 1971*, the Government announced, in *March 1972*, its decision to charge from low-income group persons uniform interest rates of 4 per cent. The Reserve bank laid down certain criteria for eligibility for loans at differential rates under the scheme.

The eligible sectors include scheduled tribes, scheduled castes and others engaged, on a modest scale, in agriculture and/or allied activities; people occupied in the collection, of elementary processing, of forest produce; people *collecting* fodder in difficult areas and selling it to farmers and traders; people physically engaged on a modest scale in rural cottage industries and vocations; students of merit going in for higher education; physically handicapped persons pursuing a gainful occupation; and orphanages and women's homes where saleable goods are made and for which there is no adequate and dependable source of finance. A person to be eligible for a loan under this scheme should not have a family income of more than Rs. 3,000 per annum if resident in an urban or semi-urban area or Rs. 2,000 per annum if resident in a rural area. In, addition, he should not have land exceeding one acre if irrigated and 2.5 acres if unirrigated.

Term loan and working capital would be granted in accordance with the specific needs of the borrower. In 1973, the ceiling for working capital loans to any single borrower was raised from Rs. 500 to Rs. 1,500 and for term loans from Rs. 2,500 to Rs. 5,000. Composite loans up to Rs. 6,500 may also be given to village artisans and persons engaged in village and cottage industries. In exceptional cases, particularly for students of merit, higher amounts

the banks to determine the quantum of working capital term loan depending upon the nature and need to the activity of the borrower. But the overall ceiling of Rs. 6,500 shall be observed.

(a) *Margin* : Margin money is not to be insisted upon.

(b) *Security* : The assets purchased with the loan may be hypothecated to that bank. In appropriate cases loans to homogeneous group of borrowers, group guarantee may be accepted. Tangible security or third party guarantee is not insisted upon.

Every loan is to be covered under the credit Guarantee Scheme and the guarantee fee should be met by the banks. The cost of insurance of the assets charged to the bank, if considered necessary, should be borne by the bank.

(c) *Repayment of loans* : The term loans are repayable within a period of five years including a grace period of up to 2 years. For each borrower a repayment schedule is worked out taking into account the nature of his activity and the surplus income he gets from the productive endeavour.

Supervision and Guidance : The banks will maintain continuous touch with the borrower to whom the benefit of the differential rate is extended and will arrange for necessary guidance and help in a number of ways either themselves or with the help of other recognised bodies which function in the area.

Lending through Regional Rural Banks : The Government has allowed the commercial banks to lend through the Regional Rural Banks sponsored by them on a refinance basis. The RRBs are required to give preference to smaller borrowers amongst landless agricultural labourers, rural artisans, cottage and rural industries, beneficiaries of schemes for Scheduled Castes/Tribes and the weakest of the weaker sections. Refinancing is provided by the commercial banks to RRBs at two per cent per annum.

District Industries Centers

The Government has set up District Industries Centers at the district level. These centers give all the services and facilities to the entrepreneurs at one place for setting up small and village

Industries. The center renders various services required by small entrepreneurs including identification of a suitable scheme, preparation of feasibility report, arrangements for supply of machinery and equipment, provision of raw materials, credit facilities and inputs, marketing and extension services.

A District Industries Center (D.I.C.) is headed by a General Manager who is assisted by seven functional managers, each is a specialist in the following subjects :

1. Economic Investigation.
2. Machinery and Equipment.
3. Research, Extension and Training.
4. Raw Materials.
5. Credit.
6. Marketing, and
7. Cottage Industries.

Role of Credit Managers : The Credit Managers have been deputed by the banks to the D.I.Cs. They provide all guidance, assistance and support required by entrepreneurs in obtaining the right type of credit in required amounts at the proper time from banks and financial institution.

The Credit Manager are needed to recommend the credit proposals of small entrepreneurs after due appraisal to the credit institutions. The entrepreneurs are therefore, not required to furnish the same particulars to banks again. The credit managers do not possess the authority to sanction loans nor are they responsible for the recovery of the loans. They act as liaison authority between borrowers on the one hand and the credit institutions on the other.

Advances to Small-Scale Industries

A small-scale industrial unit is one which is engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery (excluding land and buildings) does not exceed Rs. 10 lakhs. Small-scale industry may be distinguished from village industries and handicrafts, which are of a traditional nature and cater primarily to local markets. Small-

scale industries may be classified into five main groups, *viz.*,

- (i) *Manufacturing* industries producing finished products for direct consumption;
- (ii) *Feeder* industries **specializing** in certain types of products and services, e.g., castings, electroplating, welding;
- (iii) *Servicing* industries covering light repair shops, which are essential for the maintenance of mechanical equipment;
- (iv) *Ancillaries* to large-scale industries, producing parts and components for such light engineering products as cycles, sewing machines, diesel engines, machine tools;
- (v) Mining and/or quarrying.

Characteristics of a Small-Scale Unit :

Some of the important characteristics of a small-scale industrial unit are as follows :

- (i) Inadequate capital resources;
- (ii) Obsolete machines and tools;
- (iii) Lack of knowledge of modern methods of management, production and marketing;
- (iv) Shortage of trained personnel;
- (v) Scarcity of raw materials.

Finance for Small-Scale Industrial Units :

Like any industry, small-scale units need land, buildings, plant and machinery and such ancillary services as water, power, transport. In addition to these fixed capital requirements, there are working capital requirements for the day-to-day running of the factory.

The important sources of finance for small-scale industries are:

- (i) Proprietor's own capital;
- (ii) Loans by State Governments and State Financial Corporations;
- (iii) Finance by commercial banks;

- (iv) Finance by National Small Industries Corporation;
- (v) Finance by other agencies.

Appraisal of Loan Proposals :

In principal, there is not much of a difference between the appraisal of a proposal for an advance to a small-scale industrial unit and a big industry'. But, in actual practice, the consideration of a proposal favouring a small-scale industry raises some problems of its own. An important aspect of the basic philosophy of a bank to assist a small-scale industrial unit is its commitment to meet its total needs, irrespective of the security which it is in a position to offer; provided that the unit is technically competent to produce marketable goods, notwithstanding the need-based approach rather than the security-oriented approach of traditional bankers. Many proprietors of small units may not be able to answer the standard questionnaire except with the guidance of the banker. Such guidance should always be provided. Some small units do not keep regular account books and are not in a position to submit audited balance sheets, which are essential for an appraisal of a proposal. The appraisal of a proposal involves many things, including the character of the proprietor, the quality of management, the financial strength of the enterprise, its technical and economic feasibility as well as an assessment of its credit requirements.

In appraising an advance proposal of a small-scale industrial unit, the following factors should be considered in mind:

(i) **Proprietor (Management) :** The entrepreneur's honesty, efficiency and experience will be considered. If the unit is a one-man show, the consequences of the unexpected death of the key man in the running and progress of a unit will also be taken into account.

(ii) **Finance :** The financial strength of a unit may be assessed from a study of the statement of its assets and liabilities. It would be necessary to know the liquidity surplus or the available working funds determined out of the current assets and current liabilities because this is the quantum of free funds which will be utilized to provide a margin on the bank's advances as well as meet other

overhead expenses. The unit's balance sheet or its statement of assets and liabilities should be studied to ascertain the sources from which funds shown as unsecured borrowings really belong to the proprietors of the enterprise and are likely to be retained in the business till it gains strength. Moreover, if there is any conflict in security, a study of the balance sheet would indicate whether the security proposed to be offered to the bank is free from prior encumbrances. From the statement of assets and liabilities, all the assets should be verified to determine the liquid surplus and the extent of the stake which the owners of the enterprise have therein. While no standard formula can be laid down, a 20 per cent to 25 per cent contribution to the cost of the entire project may be taken as a reasonable stake.

The working capital needs of the unit may be assessed by anticipating the production in the next 12 months and the requirements of raw materials during the same period.

(iii) Technical Feasibility : It is necessary to investigate the capacity of a unit to produce goods. If a technical feasibility study has been made by some Government organisation or any other expert body, a copy of the report should be obtained and closely studied by the bank. The banker should also ascertain whether the machinery is second hand or new whether the factory is properly located, and whether spare parts, raw materials, labour, water and power are easily available.

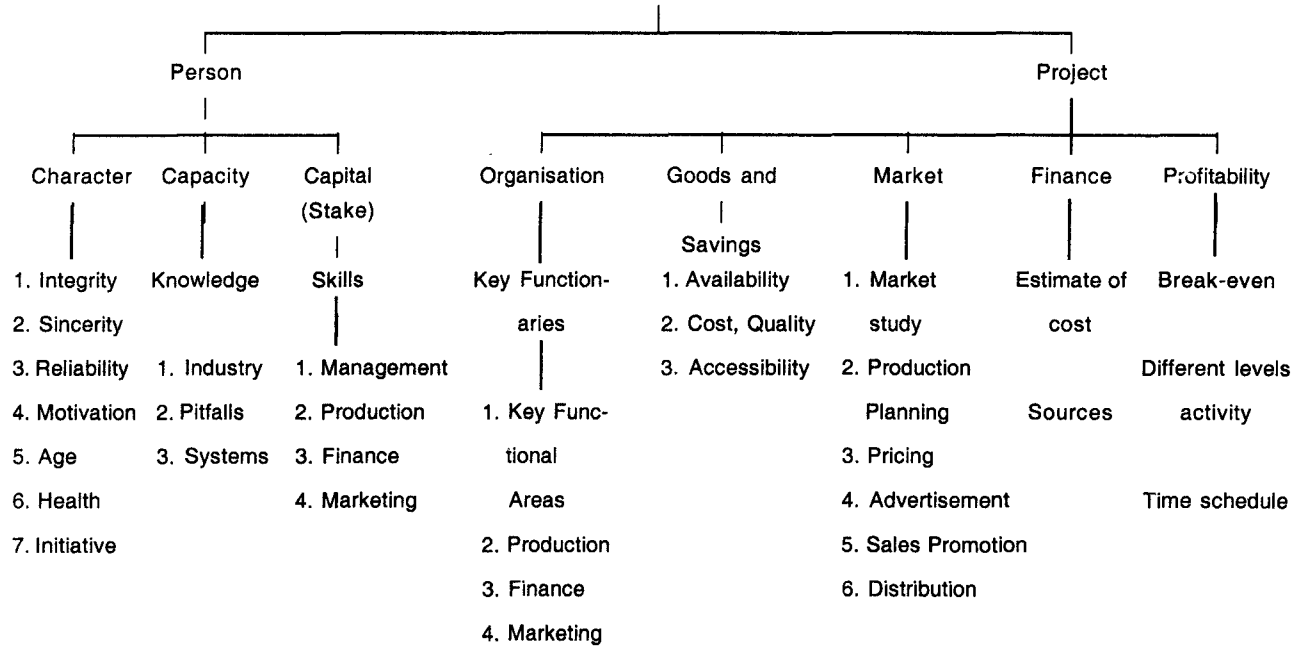
(iv) Economic Feasibility : The banker should also fix the economic feasibility of the project to find out whether:

- (i) a unit depends on raw materials which are easily available/ or in short supply;
- (ii) the products manufactured by it have a steady demand or a seasonal or fluctuating demand;
- (iii) the type of marketing organisation the unit has is adequate and satisfactory.

The Chart given here shows the various points to be considered by a bank while appraising a credit proposal before making an advance to a small-scale industry.

Chart Showing Advances to Small-Scale Industries

Capital Appraisal



(v) **Break-Even Analysis** : "The break-even point of a manufacturing organisation is defined as that level of sales at which it recovers all its costs, and makes neither a profit nor incurs a loss." Therefore, a manufacturing unit (whether small-scale or large-scale) should aim at operating at or above its break-even point, if it is not to incur a loss and deplete its capital. Once a unit crosses its break-even point, it generates a surplus. An assessment of the breakeven volume of sales provides an effective index of the viable level of activity which ought to be achieved by a unit.

Calculation of the Break-Even Point :

The first step in calculating the break-even point is to segregate the costs incurred by an organisation into fixed and variable items of cost. Fixed costs would have to be met regardless of whether the firm operates or not. Examples of fixed costs are rent, taxes, insurance, depreciation, wages of permanent labour and salaries of the supervisory staff. In practice, fixed costs are not totally independent of the level of activity. They increase with an increase in activity. For example, fixed costs may be Rs. 4,000 per month for a production which ranges from 6,000 to 8,000 units per month, and Rs. 5,000 per month when production is between 8,000 and 20,000 units per month. The increase may be caused by the employment of more permanent labour and supervisors to handle a larger volume of production.

Variable costs, on the other hand, bear a definite relation to the volume of production. For example, the consumption of raw materials is directly linked to production. Power and interest on borrowings are other items of variable costs. Most overheads, in fact, are neither completely fixed nor completely variable, but consist of both the components of the costs -- variable and fixed. For the sake of convenience, all costs, other than raw material costs, may be treated as fixed costs.

Once the fixed costs are known, the sales revenue at the break-even point is easily calculated with the help of the following formula:

$$\text{Fixed Costs Break-Even Sales} = \frac{\text{Fixed Costs}}{1 - \frac{\text{Variable Costs}}{\text{Sales Volume}}}$$

Sales revenue less, variable costs, is defined as *contribution*, and is often expressed as a percentage of selling price. Thus, the break-even sales are:

$$\frac{\text{Fixed Costs}}{\text{Contribution}}$$

Example :

A wooden toy manufacturer sells his toys at an average price of Rs. 5 per piece. The variable costs incurred on the manufacture of each toy are Rs. 3 per piece and the fixed costs are Rs. 25,000 per year.

$$\text{Contribution} = 1 - \frac{3}{5} = \frac{2}{5} = 40\%$$

$$\text{Sales at Break-Even Point} = \text{Rs.} \frac{25,000}{0.40} =$$

The break-even sales volume = 12,500 toys per year.

The unit should, therefore, sell at least 12,500 toys per year to breakeven. In practice, it may not be possible to make an exact estimate of the fixed and variable costs. However, by treating all expenses other than raw material costs as fixed costs, the appropriate break-even point can be calculated.

Example :

A leather shoe (Brand O) is sold for Rs. 25 per pair. Material costs (consisting of raw materials and packing) are Rs. 15 per price and fixed costs are Rs. one lakh per year.

$$\begin{aligned} \text{Break-Even Sales} &= \text{Rs.} \frac{1,00,000}{1 - \frac{15}{25}} \\ &= 2,50,000 \end{aligned}$$

$$\text{Break-Even Sales Volume} = \frac{2,50,000}{25} = 10,000 \text{ shoes per year}$$

The break-even point is, therefore, reached when 10,000 shoes are sold per year.

The calculation of the break-even point becomes a slightly more complicated exercise when a firm manufactures a number of products, each with a different contribution margin. In such cases, the weighted average of the contribution margin has to be calculated to find out the break-even point.

Example :

A company manufactures four types of products L, M, N & P. The contribution margins of the four products are 40%, 30%, 35% and 50% (defined here as sales revenue, less material costs) respectively. The company expects to realise 50%, 25%, 15% and 10% respectively. The fixed costs are Rs. 10 lakhs per year.

Weighted Average of Contribution Margin

$$\begin{aligned}
 &= (0.40 \times 0.50) + \\
 &\quad (0.30 \times 0.25) + \\
 &\quad (0.35 \times 0.15) + \\
 &\quad (0.50 \times 0.10) + \\
 &= 0.3775 \\
 &\text{or } 37.75\%
 \end{aligned}$$

$$\begin{aligned}
 \text{Break-Even Sales} &= \text{Rs. } \frac{10,00,000}{0.3775} \\
 &= \text{Rs. } 26.49 \text{ lakhs per year.}
 \end{aligned}$$

While studying the loan proposals of small-scale industrial units from different angles, the bank should not lose sight of two broad matters of policy. In the first place, advances to small-scale industrial units are in the national interest, and bank should, therefore, take a little more than normal risk in approving them. Second, if a loss occurs in any case, the Government shares it with the banker through the credit guarantee organisation. But this does not mean that highly risky and speculative proposals should be entertained.

Advances to Priority Sectors :

Extension of Credit to small borrowers in the hitherto neglected sectors of the economy has been one of the major tasks assigned to

the public sector banks into the post-nationalization period. To achieve this objective, banks have drawn up schemes to extend credit to small borrowers in sectors like agriculture, small-scale industry, road and water transport, retail trade and small business, which traditionally had very little share in the credit extended by banks. Taking into account the need to provide resource requirements of weaker sections, for specific needs, consumption credit (with certain limits) has been included in priority sectors. Similarly, small housing loans (not exceeding Rs. 5,000) to scheduled castes/scheduled tribes and other weaker sections are also classified as priority sector advances. Number of borrowal accounts with the public sector banks for these categories of borrowers increased from 2.60 lakh to 3.55 lakhs between June, 2008 to September, 2009. Amount outstanding during the sale period increased from Rs. 441 crores to Rs. 39,833 crores. Public sector banks accounted for 42.7 per cent of the total bank credit by Sept., 2009. The following table shows achievements of the public sector banks in stepping up flow of credit in various priority sectors.

Table 1
Public Sector Banks Advances to Priority Sectors

Sector	Amount outstanding (Rs. Crores)						
	June 1969	Dec. 1965	Dec. 1966	Dec. 1967	Dec. 1968	Dec. 1969	Dec. 2009
1. Agriculture							
(i) Direct finance	188.40	7415.13	8929.97	10341.38	12072.04	14020.29	14897.35
(ii) Indirect finance	—	1378.32	1377.49	1963.47	1498.42	1401.01	1286.43
2. Small-scale Industry	285.90	7470.70	8607.08	10190.20	12234.79	14281.40	15373.02
3. Road & Water transport operators	8.20	1882.70	1958.62	2016.30	2166.05		
4. Professional & Self-employed persons	0.30	453.29	833.68	991.93	1012.17		
5. Retail Trade & Small Business	—	1721.50	2122.49	2599.54	3137.99	7643.01	8275.76
6. Education	0.50	32.68	35.85	45.56	55.15		
7. Housing	—	63.80	106.06	167.01	228.94		
8. Consumption	—	21.07	18.91	30.00	24.44		
9. Other Priority Sectors	—	8.61	18.13	95.18	142.45		
	483.30	20647.88	20085.28	27940.57	32662.14	37345.71	39832.56

Credit to Weaker Sections (Differential Rate of Interest — DRI — Scheme) :

To increase credit flow to small and poor borrowers, weaker sections comprising of small and marginal farmers, landless labourers, tenant farmers and share croppers, artisans, village and cottage industries, beneficiaries of Integrated Rural Development Programme, Scheduled Castes and Schedules Tribes, a Differential Rate of Interest (DRI) scheme has been evolved. This scheme was slated to receive not less than 10 per cent of net bank credit by March, 1985. By Sept., 2009, weaker sections had received Rs. 9961 crore and accounted for 10.7 per cent of aggregate advances of public sector banks.

□□□

CHAPTER



COMMERCIAL BANKING IN INDIA

A commercial bank in India is that financial institution which performs all the ordinary banking functions and operates in the control and supervision of the Reserve Bank of India. The commercial banking sector in India has within its fold :

- (i) the State Bank of India,
- (ii) seven Associate banks of the State Bank of India,
- (iii) nineteen nationalised banks,
- (iv) Indian joint-stock commercial banks,
- (v) foreign banks working in India, and
- (vi) Regional Rural Banks.

From the point of view of ownership, there are 27 commercial banks (the State Bank of India, its subsidiaries and 19 nationalised banks) in the public sector. Each Regional Rural Bank is also sponsored by a public sector bank. Other banks operate in the private sector either as joint-stock banks or as branches of foreign banks. All these banks have been defined as Banking Companies in the Banking Regulation Act, 1949. In terms of the Reserve Bank of India Act, 1934, the commercial banks have been defined as the scheduled commercial banks and the non-scheduled commercial banks. Since

the non-scheduled banks have a very insignificant place in the Indian banking system, the scheduled commercial banks, therefore, hold the real significance for all practical purposes. Some cooperative banks have also been termed as scheduled banks but they are different from the scheduled commercial banks.

History of Commercial Banking in India :

Modern researches have revealed that the business of banking was perfectly understood and fairly practiced by the people of ancient India. During the early Muslim and Mughal periods the indigenous bankers played an important role in financing trade and lending money to business men and rulers. However, the development of modern banking in India began with the banking activities undertaken by the English Agency Houses at Kolkata and Mumbai, which combined banking with trading. It appears that the earliest bank on western lines was established at Chennai in as early as 1683. The first joint-stock bank, *the Bank of Hindustan*, was established at Calcutta in 1770 by M/s. Alexander and Co. The bank was wound up in 1832 after the failure of the founder company.

The most important step taken in the direction of banking development was the establishment of Presidency Banks at Calcutta (1806), Mumbai (1840) and Chennai (1843). Besides ordinary banking functions, these banks also functioned as bankers to the Government. In 1921, these three banks were amalgamated to give birth to the *Imperial Bank of India*. It was this bank which performed some of the functions of a central bank also until the establishment of Reserve Bank of India in 1935. The Imperial Bank was nationalised as the *State Bank of India* in 1955.

The first joint-stock bank with limited liability, the *General Bank of India*, was set up in 1786, but it perished in 1793. The Act of 1860 permitted the organisation of joint-stock banks with limited liability. As a result some big banks came into existence, prominent among them being the *Allahabad Bank* (1865), the *Alliance Bank of Simla* (1865), the *Oudh Commercial Bank* (1881), the *Punjab National Bank* (1894), and the *People's Bank of India*, (1901). Up to 1874, 14 joint-stock banks with limited liability were established mostly by the Europeans. The first fully Indian bank was the Oudh Commercial

Bank followed by the Punjab National Bank and the People's Bank of India. However, all the banks established during this period, except the Allahabad Bank and the Punjab National Bank, failed subsequently.

The next stage of the development of joint-stock banking began in 1906 with the launching of the Swadeshi Movement. As a result the *Bank of India* (1906), the *Canara Bank* (1906), the *Indian Bank of Madras* (1907), the *Bank of Baroda* (1908), the *Central Bank of India* (1911) and a large number of small banks were established before the outbreak of First World War in 1914. In 1913, there were 13 big banks, each having capital and reserves exceeding Rs. 5 lakhs, and about 500 small banks operating in the country.

As in all other countries, banking in India had its teething troubles. The banking crises developed from time to time and resulted into failure of many banks. There was a serious banking crisis between 1913 and 1917 when 87 banks with a total paid-up capital of Rs. 175 lakhs had failed. Another crisis developed between 1921 and 1924. The Great Depression of 1930s also affected the banks adversely. Between 1922 and 1936, no less than 373 banks had collapsed. 372 more banks closed their doors between 1936 and 1940. The banks in Southern India particularly had failed in a larger number during this period.

The Second World War gave an opportunity of development and expansion of banking in India. Some of the most important banks established during the war period were the *United Commercial Bank*, the *Hindustan Commercial Bank*, the *Hindustan Mercantile Bank*, the *Bank of Rajasthan*, the *Bank of Maharashtra*, the *Indian Overseas Bank*, and the *Dena Bank*. But the growth of banking was neither well planned nor properly controlled. Between 1939 and 1943, 482 banks with a total paid-up capital of Rs. 94 lakh had failed. These were mostly small banks.

In 1947, the partition of the country put a heavy strain on the banks. The Reserve Bank and the Government helped the banks facing crisis and some of these escaped failure. Between 1947 and 1951, the number of bank failures each year was 37, 45, 53, 45, and 62 respectively.

An important feature of banking development during the war and post-war period was that the association of industrialists with banks became closer. Most of the industrial houses organized banks of their own or obtained control over already established banks. In a virtual scramble for funds, many banks undertook branch expansion quite out of proportion to their resources and without any careful assessment of the business prospects of the towns. Other conspicuous features of the mushroom banks were the inter-locking of shares between banks and other companies in which management was interested, large unsecured advances to persons connected with the management, and advances against speculative shares with inflated prices.

The Reserve Bank of India was given big powers of supervision and control over banks under the Banking Companies Act 1949—renamed as the Banking Regulation Act from March 1966. It gave suitable direction to the banking development. In 1960, after the failure of the Palai Central Bank, the Reserve Bank intensified its efforts to strengthen the banking stricture. During the period 1960-67, over 200 banks were amalgamated. In July 1969, 14 major Indian scheduled commercial banks were nationalised with the result that together with the State Bank Group, 80 per cent of the banking business came under the direct control and ownership of the public sector. After the nationalization of six more banks on April 15, 1980, the share of public sector banks in total deposits and outstanding credits increased to 90.8 per cent and 90.7 per cent respectively. Commercial banking in India is now a strictly regulated sector in the Indian economy.

Regulation of Banking :

One of the specific functions given to the Reserve Bank of India was "to regulate the banking system." In the early years, the regulation of the banking system was not effective mainly because the creation of the Reserve Bank coincided with "an ease of rates and plentitude of funds, which had no parallel in our previous history". The position, however, changed considerably since the World War II. The super abundance of funds with commercial banks disappeared. The increasing recourse to the Reserve Bank made the

banks more amenable to its control. The adoption of economic planning in the country gave a new accent to the regulation of banking.

The Reserve Bank has been vested with extensive powers of supervision and control over all commercial banks under the provisions of the Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949, with several amendments. The Bank's regulatory functions relating to banks cover their establishment (*i.e.*, licensing), branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. The Reserve Bank has a separate department, the *Department of Banking Operations and Development*, which is concerned with supervision, control and development of commercial banking in India.

Banking Regulation Act, 1949 : Before 1949, there was no separate legislation governing the banking sector. Indian Companies Act, 1913, governed banking companies in common with other companies. This Act contained a few provisions especially applicable to banks. The Banking Companies (Inspection) Ordinance, 1946, the Banking Companies (Restriction of Branches) Act, 1946, and the Banking Companies (Control) Ordinance 1948, covering particular regulatory aspects paved the way for the enactment of the Indian Banking Companies. Act, 1949. It has come to be renamed as Banking Regulation Act, 1949, from March 1966. Important changes in several provisions of the Act were made from time to time, designed to enlarge or amplify the powers and responsibilities of the Bank, or to impart flexibility to the relative provisions.

The private sector banks and foreign banks, which are 'banking companies', as defined in section 5(c) of the Banking Regulation Act are, in their functioning and management, governed by the provisions of the Banking Regulation Act. The other categories of banks (State Bank of India and its associate banks, nationalised banks and Regional Rural Banks) are governed both by the provisions of the respective enactment's under which they have been set up and by those provisions of the Banking Regulation Act,

which have been specifically made applicable to them, in terms of Section 51 of that Act.

The Banking Regulation Act has defined banking and laid down permissible functions which are incidental or conducive to the promotion or advancement of banking (Sec. 6). All banks (except those in the public sector and Regional Rural Banks) are required to obtain a license from the Reserve Bank for commencing or continuing banking business (Sec. 22). The Bank's permission is also necessary for opening new branches (Sec. 23). No agreement, arrangement, or action for amalgamation of any banking company with another on a voluntary basis may be made without approval of the Reserve Bank (Sec. 44A). The Reserve Bank acquired additional statutory powers for the reconstruction/compulsory amalgamation of banks by an amendment of the Act in 1960.

The Banking Regulation Act has prescribed minimum requirements of paid-up capital and reserves, cash reserve and other liquid assets (Sees. 11, 17, 18 and 24). The minimum paid-up capital and reserves vary according to the geographical coverage of a bank's operations. The absolute minimum requirement varies between Rs. 5 lakhs and Rs. 20 lakhs after coming into effect the amendment of the Act in 1962. In terms of the amendment of the Act in 1962, the scheduled banks are required to maintain with the Reserve Bank minimum cash reserves of 3 per cent of their aggregate demand and time-liabilities. This can be varied between 3 and 15 per cent. The non-scheduled banks can maintain the cash-reserves partly with themselves and partly with the Reserve Bank, the State Bank, etc. In addition to this, all banks are required to maintain with themselves liquid reserves amounting to not less than 25 per cent of their total demand and time liabilities in India. This is known as the Statutory Liquidity Ratio. The Banking Laws (Amendment) Act, 1983, empowers the Reserve Bank to vary SLR from 25 per cent to the extent of 40 per cent by issue of a notification. The Reserve Bank is further empowered to impose penal interest on banking companies which default in the maintenance of SLR.

The statutory inspection of banking companies by the Reserve Bank, under Section 35 of the Act, is the most significant of the

supervisory functions of the Bank. In particular, the Bank is empowered to inspect, make an inquiry or determine the position in respect of matters specified in the Act, *e.g.*, to satisfy itself regarding the minimum requirements of capital (Sec. 11), eligibility for licenses (Sec. 22), opening of branches (Sec. 23), amalgamation (Sec. 44 A), suspension of business and compromise or arrangement with creditors/members, etc. (Sees. 37, 44B and 45), or compliance with any directions issued by the Bank (Sec. 21). The Reserve Bank examines a bank's affairs with particular reference to the methods of operation, its investment and lending policies, the state of assets, the quality of management, the extent to which it has complied with the various statutory provisions, etc. A system of regular inspection was instituted in March 1950. The banks are required to submit a number of returns to the Reserve Bank. Balance sheets and profits and loss accounts are required to be audited by qualified auditors and put on display.

Any shortcomings found in the working of the banks are brought to their notice and they are called upon to submit periodical reports showing the progress achieved by them in the direction of eliminating defects. The Reserve Bank takes necessary steps in bringing about the desired degree of improvement.

With a view to ensure that commercial banks do not fritter away funds in improper investments and injudicious advances, the Reserve Bank exercises strict control over the operations of the banks. Section 8 of the Act prohibits banks from engaging in trading activities. Any immovable property held by a bank other than that required for its own use, has to be disposed of within a specified period. Under Section 21, the Bank is charged with the responsibility of determining the policy in relation to advances to be followed by banks and of giving direction to them in this regard.

The Banking Regulation Act contains certain provisions to ensure that banks are under proper management. No bank can employ or be managed by a managing agent (Sec. 10). It cannot employ, on a regular basis, any person whose remuneration takes the form of commission or of a share in the profits of the company. With a view to avoiding control of banking funds by big finance,

interlocking of directorates of banking companies is not permitted (Sec. 16) and except for bonafide commercial transactions, making of unsecured loans and advances to directors is prohibited (Sec. 20). Appointment and remuneration of chairmen/ chief executive officers is subject to the approval of the Reserve Bank (Sec. 35 B), and the Bank has powers to remove managerial and other persons from office (Sec. 36 AA), It can also appoint additional directors of banking companies (Sec. 36 AB).

Social Control Over Banks : The Government initiated the scheme of social control over banks in December 1967 with a view to ensure that bank credit was distributed equitably and purposefully among the different sectors of the economy. The scheme of social control over banks was later given a legal framework under the Banking Laws (Amendment) Act, 1968, which came into force in February 1969. The objectives of this scheme were to achieve "a wider spread of bank credit, preventing its misuse, directing its flow to priority sectors and making it a more effective instrument of economic development." For this purpose, a high level body called the National Credit Council was set up in February 1968 with the Finance Minister as the chairman and the Governor of the Reserve Bank as vice-chairman.

The important changes introduced under the scheme of social control over banks related to the reconstitution of the Boards of Directors of banks with a majority of non-industrialist directors having specialized knowledge or practical experience useful to a bank, the appointment of professional bankers as chairmen of banks, the prohibition of loans and advances to directors and their concerns, and the power conferred on the Central Government for the acquisition of recalcitrant banks in specified circumstances. The Reserve Bank was given the power to remove the chairman, if considered necessary, and appoint its own nominee as chairman, if the bank's nominee was not acceptable to it. The Bank was also empowered to appoint a director or observer on the Boards of the commercial banks. The Banking Laws (Amendment) Act, 1983, puts a limit to the tenure of directors of a banking company, empowers the Reserve Bank to decide if a change is permissible in the number

of directors, as also to appoint a chairman, if such appointment is deemed necessary. Nationalization of Banks

It was very soon realised that the social control experiment was basically inadequate to achieve the social goals. It was considered to be inadequate to achieve the desired results with sufficient promptitude. It was felt that the desired objectives could be achieved only through public ownership of banks.

The Government of India nationalised fourteen major Indian scheduled banks, each having deposits of Rs. 50 crores or more, by issue of an Ordinance on July 19, 1969. The nationalization Ordinance was replaced by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969, which expressed in its preamble that the main objects of the nationalization of banks are "to control the heights of the economy and to meet progressively, and serve better, the needs of development of the economy in conformity with national policy and objectives." Since the Supreme Court declared the Act invalid, a fresh Ordinance was issued on February 14, 1970 re-nationalizing the 14 banks. This was replaced by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, which was enforced retrospectively with effect from July 19, 1969.

The foreign banks operating in India was not nationalised on the grounds of they're special position and specialized business. Banks with deposits of less than Rs. 50 crores each were also not nationalised mainly because they had only a small share in the total banking business.

The aggregate volume of deposits of 14 nationalised banks, on the eve of nationalization, was equivalent to 56 per cent of the total deposits of all the commercial banks in India. Together with the State Bank of India and its seven subsidiaries, there were now 22 banks in the public sector, which accounted for 83.3 per cent of aggregate deposits, 83.8 per cent of aggregate advances and 81 per cent of total bank offices, as in June 1969.

Six more scheduled commercial banks in the private sector were nationalised on April 15, 1980 under the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1980. The

basis for nationalization of these banks was that the demand and time liabilities of each of these banks exceeded Rs. 200 crores as on March 14, 1980. A total amount of Rs. 1 8.50 crores was made payable as compensation through the boards of directors to the shareholders of these six banks.

Consequent to the nationalization of these six banks the number of public sector banks increased to 28 (comprising the State Bank of India and its 7 subsidiaries and 20 nationalised banks) exclusive of Regional Rural Banks. The share of public sector banks in the total deposits and outstanding credits, rose from 84.1 per cent and 84.2 per cent, respectively, to 90.8 per cent and 90.7 per cent, respectively.

In September 1993, the New Bank of India, a nationalised bank, was merged with the Punjab National Bank. This has reduced the number of nationalised banks to 19.

State Bank of India :

The State Bank of India has grown into a giant institution and is the leader in the banking system of the country. Its progenitor, the Imperial Bank of India, which was formed in 1921 by amalgamating the three Presidency Banks, also occupied a unique position in the Indian money market as a semi-central bank. The State Bank of India Act was passed in 1955 and the State Bank of India was constituted on July 1, 1955. It took over the assets and liabilities of the Imperial Bank. The shareholders of the Imperial Bank were suitably compensated.

The State Bank of India Act, 1955 provided for an authorised capital of Rs. 20 crores divided into 20 lakh shares of Rs. 100 each. The issued and paid-up capital of the State Bank was Rs. 5.625 crores which was allotted to the Reserve Bank in lieu of the shares of the Imperial Bank transferred to it. The State Bank was authorised to increase the issued capital up to Rs. 12.5 crores without any prior sanction of the Government. It was, however, essential that the Reserve Bank should hold a minimum of 55 per cent of the issued capital. Shares of the State Bank up to 45 per cent of its total issued capital could be transferred to the Imperial Bank shareholders and others. There was a restriction that no individual could be allowed

to hold more than 200 shares either in his name or jointly with any other person. It is obvious that the State Bank of India was not intended to be a fully state-owned bank. The Reserve Bank, however, acquired 92 per cent of its shares and only 8 per cent were transferred to other individuals and institutions. Thus, it came under the effective control of the Reserve Bank and the Government.

An ordinance issued in October 1993, amended the State Bank of India Act, 1955 to enable the State Bank of India (SBI) to raise money from the market. The amendments provide for reduction in the face value of the bank's share from Rs. 100 to 10, removal of the limit on an individual holding of 200 shares and an increase in the limit of voting rights from one per cent to ten per cent.

An important development in 1993-94 was the entry of SBI into the domestic capital market with an equity-cum-bond issue of Rs. 2,532 crore, with a view to achieving the capital adequacy norm of 8 per cent by March 31, 1994. The Bank mobilised a massive sum of Rs. 3,206 crore, including over subscription retained by it. With this, the issued and paid-up capital of SBI increased to Rs. 473.83 crore from Rs. 200 crore earlier. The share-holding of the Reserve Bank in the equity of SBI came down to 68.9 per cent from the existing 98.2 per cent before the issue. The shareholding of the Government and the Reserve Bank in the capital of State Bank of India constituted 1.8 per cent and 59.7 per cent, respectively during 1998-99. The Bank attained a capital adequacy ratio of 14.58 per cent in 1997-98. The ratio stood at 12.51 per cent as at end March 1999.

Associate Banks : The Rural Credit Survey Committee had recommended the establishment of the State Bank of India by amalgamating with the Imperial Bank ten major State-associate banks. The State Bank of India (Subsidiary Banks) Act, 1959 enabled the State Bank of India to take over those State-owned or State-associated banks which were willing to become its subsidiaries. The State Bank of Hyderabad became the first-subsidiary of the State Bank on October 1, 1959. The Bank of Jaipur, the Bank of Indore, the Bank of Bikaner and the Travancore Bank followed on January 1, 1960. The Bank of Mysore, the Bank of Patiala and the State Bank of Saurashtra became subsidiaries of the State Bank on March 1, April 1, and May 1, 1960, respectively. The word 'State' was affixed

before their former names. Subsequently, the State Bank of Bikaner and the State Bank of Jaipur were integrated as one unit on January 1, 1963. This reduced the number of subsidiary banks from 8 to 7. These seven subsidiary or associate banks together with the State Bank of India form what is popularly known as the 'State Bank Group' of banks.

The State Bank must hold at least 55 per cent share-capital of an associate bank, except the three which were formerly owned by the Government and in whose case the State Bank holds the entire share capital. No individual is allowed to hold more than 200 shares in the capital of an associate bank. The management of these banks is entrusted to their respective Boards of Directors. They maintain their own independence in the day-to-day operations, while the State Bank has the general powers of control, supervision and direction over them. An associate bank, in addition to its own business, acts as an agent of the State Bank, transacts business on behalf of the Central and State Governments, and undertakes such other business as may be entrusted to it by the Reserve Bank. Their association with the State Bank has imparted to them sufficient strength and stability so as to place them in a position to undertake enlarged responsibilities.

Subsidiaries : Within the country the State Bank Group comprises State Bank of India, seven Associate Banks, one fully owned banking subsidiary *viz.*, SBI Commercial and International Bank Ltd., and five non-banking subsidiaries *viz.*, SBI Capital Markets Ltd., SBI Gilts Ltd., SBI Securities Ltd., SBI Funds Management Ltd., and SBI Factors and Commercial Services Ltd. In addition, SBI Home Finance Ltd., is an affiliate of the Bank. The Bank has three fully-owned subsidiaries abroad *viz.*, SBI European Bank Ltd., SBI Canada and SBI California. Four joint ventures are : Nepal SBI Bank Ltd., Bank of Bhutan, SBI International Ltd., Mauritius and Indo-Nigerian Merchant Bank Ltd., Lagos.

Functions and Achievements :

The State Bank of India is basically a commercial bank. It undertakes ordinary commercial banking business and provides credit to industry, trade, commerce and agriculture as the erstwhile

Imperial Bank of India used to do. An important function assigned to the State Bank was to promote banking development through the establishment of an effective machinery of branches spread over the whole country. It was required to promote banking in rural areas and to play an important role in the development of rural credit and to assist cooperative societies in the rural areas. It was also required to provide loans and advances to the small scale industries. In addition to its ordinary banking and development functions, the State Bank acts as an agent of the Reserve Bank of India at all places in the country where it has a branch but there is no branch of the Banking Department of the Reserve Bank. It performs clearing house functions and is required to pay, receive, collect and remit money, bullion, and securities on behalf of the Government of India and transact any other business which the Reserve Bank may entrust to it from time to time. In certain cases, it provides refinancing facilities to other commercial banks. All these functions give it the status of a semi-central bank and lend it great prestige.

The State Bank of India and its seven Associated Banks constitute the second largest segments of the public sector banks. With 8,859 branches of the State Bank of India and 4,316 branches of the Associate Bank on June 30, 1999, the Group accounted for over 20 per cent of the total branches of commercial banks in India. State Bank is obviously one of the biggest branch banking institutions in the world. It is significant to note that out of every four of its branches about three are working in rural and semi-urban areas. During 1998-99 the total assets of State Bank Group accounted for 37 per cent of the assets of the public sector banks and 30 per cent of the total assets of entire scheduled commercial banks.

State Bank of India's market share in the aggregate deposits and total credit of all scheduled commercial banks is about 21 per cent. Its share in the total resource outflow to the commercial sector is about 20 per cent, whereas its share in total investments in Government securities is about 23 percent. SBI Gilts Ltd. was incorporated as a subsidiary of SBI in March 1996 to act as a Primary Dealer in the Government Securities market.

An important event in the recent history of the Bank was the successful floatation of the Global Depository Receipt (GDR) issue during October 1996. This was the first GDR issue by any commercial bank in the country. The objective was to augment the Bank's capital resources so as to enable it to operate in the competitive global environment on safe, sound and profitable lines.

The State Bank has opened its offices in foreign countries which assist in the promotion of India's exports by providing increasing credit facilities and the required information on trade and the standing of Indian exporters to the importers of goods from India. State Bank has a significant overseas network represented by 51 offices in 35 countries. The Bank presently benefits from relationship with a group of more than 900 correspondent banks worldwide. The Bank has three wholly-owned subsidiaries and four joint ventures abroad. It has already earned a reputation for its capability in the area of syndicated loans and is an established player in the Asian Loan Market.

In 1986 the State Bank set up SBI Capital Markets Limited (SBICAP) as a wholly owned subsidiary. This subsidiary is now in the forefront of capital market activities in the country. Besides providing timely and adequate support to the corporate sector through CDs and CDs, SBICAP is expected to develop packages, including post-issue services, and counselling for the corporate sector. SBICAP is also helping development of a secondary market in these instruments besides offering equity support to companies under its Equity Support and Venture Capital Schemes. Besides Issue management, SBICAP has a leasing and hire purchase portfolio and an active treasury department. In addition, the company has given a special thrust in the area of corporate finance and advisory services.

The State Bank launched a Mutual Fund called SBI Mutual Fund in July 1987, under the trusteeship of SBICAP. It has launched several schemes such as Magnum Regular Income Scheme, Magnum Monthly Income Scheme, Magnum Tax Saving Scheme, Magnum Growth Scheme, Magnum Equity-linked Savings Scheme, etc., which have attracted enthusiastic response. Management of SBI

Mutual Fund has since been spun off to a subsidiary, *viz.*, "SBI Funds Management Ltd."

SBI Securities Ltd. was incorporated as the stock-brooking subsidiary of the SBI Group in March 1997.

The State Bank has set up on February 26, 1991 a factoring subsidiary in the Western Zone, with its headquarters at Mumbai. SBI Factors and Commercial Services Ltd., is a joint effort of State Bank of India (54 per cent share), Small-scale Industries Development Bank of India (20 per cent), State Bank of Saurashtra (10 per cent), Union Bank of India (10 per cent) and State Bank of Indore (6 per cent). It has a subscribed capital of Rs. 25 crore. SBI Factors provides factoring services to industrial and commercial enterprises and is operating profitably. The company is set to enter export factoring and has arranged a line of credit in foreign currency.

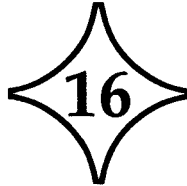
SBI Home Finance Ltd., has been set up, as the Bank's affiliate, through the agency of SBICAP and in collaboration with the Housing Development and Finance Corporation Ltd. It has laid stress on individual housing loans.

The State Bank has, obviously, taken steps on an ongoing basis to blend its business goals with social obligations. It has starved to serve the community in more ways than only financial. It has been a pioneer in many fields of activity, shifting the focus of commercial banking in the country from purely profit-making operations to developmental banking.

It has served the needs of diverse sectors of the economy—small and large, rural and urban, private and public, domestic and international.

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CHAPTER



NATIONALISED COMMERCIAL BANKS

The Government of India nationalised fourteen important Indian scheduled banks in the private sector, having deposits of Rs. 50 crores or over each, as on the last Friday of June 1969, with effect from July 19, 1969. The aggregate deposits of these fourteen banks, at the end of 1968, amounted to Rs. 2,741.8 crores, nearly 72 per cent of the total deposits of the Indian scheduled banks. Their advances amounting to Rs. 1,743.6 crores were 65 per cent of the total advances. These banks had a total paid-up capital of Rs. 28.5 crores which was about 1 per cent of their aggregate resources. Their owned funds at the end of 1968 amounted to Rs. 66.0 crores and their aggregate net profits amounted to Rs. 6.6 crores.

The oldest of the major banks was Allahabad Bank (1865) and the youngest was United Bank of India (1950). Since United Bank of India was set up by amalgamating four existing banks it would not be proper to consider it as an altogether new bank. This way, United Commercial Bank established in 1943 was the youngest of all these banks. Allahabad Bank, before, its nationalization, was subsidiary of a foreign bank—Chartered Bank. All others were fully Indian banks mostly set up and dominated by big industrial houses. They

were constituted as joint stock companies with limited liability and, therefore, each of these banks used to add 'The' before its name and 'Ltd.' after its name. For example, The Central Bank of India Ltd., The Bank of India Ltd., etc.. From the point of view of the number of offices opened by each of the major banks before nationalization, Punjab National Bank had the highest (544) and Allahabad Bank the lowest number (128) as at the end of 1968. Actually, the position and the size of a bank are judged on the basis of its deposits and advances. On this basis, Central Bank of India was the biggest followed by Bank of India, Punjab National Bank, Bank of Baroda, United Commercial Bank, Canara Bank, United Bank of India, Allahabad Bank, Syndicate Bank, Indian Overseas Bank, Indian Bank and Bank of Maharashtra. At the end of 1968, Central Bank of India had aggregate deposits amounting to Rs. 433.27 crores. Bank of Maharashtra was the smallest of these banks, having deposits of Rs. 73 crores.

It is remarkable to note that even among the 14 commercial banks, the bulk of the deposits and advances (about 63 per cent) was controlled by the first five major banks. Of the total owned funds of Rs. 66 crores, the big five banks accounted for about 64 per cent, while their share in the aggregate net profit was about 70 per cent. Some large business houses, who controlled these banks, claimed a lion's share of the bank's resources. By nationalizing the major banks, the Government secured control over what Mrs. Indira Gandhi described as "the commanding heights of the economy."

The most important reasons for nationalization of commercial banks related to the structure, policies and working of the private commercial banks. The banks had expanded their business and increased the number of their offices. There was a five-fold increase in their deposits between 1951 and 1969. Over the years, the Indian banks were made sound and viable through a system of licensing and inspection by the Reserve Bank and encouragement of mergers and amalgamations. The Reserve Bank was given wide powers to regulate the functioning of banks. Practically, however, banks were not serving the public interest and they had failed to provide credit for the desired priority channels. Instead, they had become tools in the hands of monopolists and been encouraging speculative activity.

The 'social control' measures had failed to prevent misuse of bank credit. All these factors led to the take-over of major banks in 1969. The immediate causes responsible for nationalization of banks were political in nature, but there was adequate justification for the action purely on economic and social considerations.

Smt. Indira Gandhi announcing the nationalization in a broadcast to the nation on July 19, 1969 said ; "The purpose of expanding bank credit to priority areas which have hitherto been somewhat neglected as also (1) the removal of control by a few, (2) provision of adequate credit for agriculture and small industry and exports, (3) the giving of a professional bent to bank management, (4) the encouragement of new classes of entrepreneurs, and (5) the provision of adequate training as well as reasonable terms of service for bank staff still remain and will call for continuous efforts over a long time. Nationalization is necessary for the speedy achievement of these objectives."

Six more commercial banks, nationalised on April 15, 1980 were : Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank and Vijaya Bank. These six banks had shown a phenomenal growth in their operations during the past decade. The priority sector advances of the six banks constituted 30.9 per cent of their total advances at the end of 1978. Their record in branch expansion was also quite impressive. It is remarkable to note that the six banks had an average of 40 per cent of their branches in the rural areas. Among the six banks, Punjab and Sind Bank in particular, exhibited the highest growth-rate in branch-expansion, depositmobilisation and advances. Keeping their all-round progress in view, the question arises that why these six banks were nationalised.

The reasons given officially for nationalization were simple and straightforward and almost the same ones as in 1969. Better credit-planning and larger allocations to priority sectors were the guiding factors. The cut-off point this time was placed at over Rs. 200 crores of deposits as on March 14, 1980 as against Rs. 50 crores in 1969.

The ordinance for the acquisition and transfer of the six banking companies says in the preamble that these have been taken over

“having regard to their size, resources, coverage and organisation, in order further to control the heights of the economy, to meet progressively, and serve better, the needs of the development of the economy and to promote the welfare of the people, in conformity with the policy of the State towards securing the principles laid down in Clauses (B) and (C) of Article 39 of the Constitution.” The nationalization of six more banks in 1980 can, thus, be considered as an extension of the measure of nationalization initiated in 1969.

New Bank of India, one of the six banks nationalised in 1980, had been making losses during the past four years. With the introduction of prudential accounting standards in April 1992, the imbalance in the financial position of the New Bank of India came into sharper focus. In these circumstances, it became necessary in the interests of depositors to merge it with a stronger bank. In September 1993, it was merged with the Punjab National Bank. This was the first time that a nationalised bank was merged.

Progress of Banking after 1969 :

It was intended to achieve the broad aims of bank nationalization through a two pronged approach: one, expanding the banking network in all parts of the country with special emphasis on setting up adequate banking facilities in hitherto unbanked or under-banked areas: and two, making bank credit available to all segments of the economy and regions of the country. As it is obvious from the account given below, remarkable success has been achieved in both these respects.

Branch Expansion :

A significant feature of banking development after nationalization of major banks has been the increasing tempo of branch expansion. Over the period of several decades in which modern banking developed in India till June 1969, commercial banks had opened 8,262 offices. The number of offices of commercial banks has increased to 64926 at the end of June 1999. As a result of branch-expansion by banks, the national average population per bank-office has declined from 65,000 at the time of nationalization in 1969 to less than 15,000 at the end of June 1999.

A rapid branch expansion was witnessed in the seventies and the eighties. In recent years, however, there has been considerable emphasis on the consolidation of the banking system. Towards that end the branch Licensing Policy for the period April 1985 to March 1990 (extended up to March 1993) was formulated keeping in view the need for banks to concentrate on consolidation of their position and achieving a coverage of 17,000 population (1981 census) per bank office in rural and semi-urban areas of each block and providing banking facilities in those pockets of rural areas where wide spatial gaps existed. With the adoption of the Service Area Approach in 1989, it had become necessary to allow opening of additional branches in rural areas so that the number of villages allocated to a rural branch was within a manageable limit of 15 to 25 villages per bank branch. In other areas, opening of branches was allowed purely on viability criteria.

“Approach to Future Branch Expansion” circulated by the RBI in September 1990, prescribed that the phase of consolidation was to continue with emphasis on all-out effort to improve operational efficiency, quality of assets and financial strength of banks and the future growth of bank offices will depend on well-established need, business potential and financial viability of the proposed offices.

The main thrust of the branch licensing policy for 1990-95 continued to be on providing freedom to banks to rationalize the structure of their branches. Accordingly, the distance stipulation of 400 meters between two branches of banks in towns was withdrawn. Banks were allowed to open one specialized branch per center each in the category of industrial finance, NRI and Treasury branches without the prior approval of the Reserve Bank. They could also convert their non-viable rural branches into Satellite Offices on certain conditions and provide locker facilities in extension counters. Banks were allowed to close, on mutual consultation, one loss-making branch at rural centers served by two commercial bank branches excluding RRBs.

On expiry of the Branch Expansion Programme, 1990-95, no fresh branch expansion programme was drawn up. Banks have been given the operational freedom to open and relocate branches at semi-urban, urban and metropolitan centers subject to approval

of respective Boards and ensuring track record of profit in the last three years. The loss making banks are subject to restrictions on opening of branches. With regard to opening up a branch in rural areas, prior approval of the Reserve Bank is required subject to certain conditions. Banks falling under the category of having achieved 8 per cent capital adequacy ratio, declaring net profit for the last three consecutive years, containing their non-performing assets within 15 per cent of their total advances and with a minimum of Rs. 100 crore as owned funds have to prepare a Plan of Action for opening branches during the next 12 months. This has to be forwarded to the Reserve Bank for prior approval after taking clearance from the concerned Board of Directors.

Commercial banks have opened specialized branches for industrial finance, agricultural finance, small-scale industries, capital market services, corporate finance, asset recovery management in addition to overseas NRI and other purposes.

Some Indian banks have opened their branches in foreign countries. There were 95 foreign branches of Indian banks in operation at the end of June 1999.

Dispersal of Bank Offices :

Two aspects need to be underlined in this context: first, the thrust of expansion was primarily in unbanked areas; secondly, branch expansion was planned in such a manner as to reduce regional disparities in banking development.

Of the new offices opened between July 1969 and June 1993, about 66 per cent offices were opened in unbanked centers. Since a large number of unbanked centers were in rural areas, the pace of branch expansion made considerable progress in penetration into the rural areas. The proportion of bank offices in rural areas to the total was 22.1 per cent at the end of June 1969. This proportion increased to 57.8 per cent at the end of June 1993. Despite slow expansion of rural branches in subsequent years the proportion of rural branches was 50.6 per cent as on June 30, 1999.

The regional disparities in the distribution of bank offices have also declined substantially after 1969. The under-banked States

and Union Territories have received special attrition in banking development. Regional disparities in respect of distribution of bank-offices still continue; the southern region accounts for the largest share, while the north-eastern and eastern regions are lagging far behind other regions. But the disparities are less pronounced now.

Mobilisation of Deposits :

The commercial banks have made concerted efforts at deposit mobilisation through a series of measures and schemes. The aggregate deposits of scheduled commercial banks had increased from Rs. 881 crores at the end of March 1951 to Rs. 4,646 crores at the end of June 1969. The deposits increased very rapidly after nationalization of major banks. Aggregate deposits of scheduled commercial banks at the end of September 1999 stood at Rs. 761,678 crore. The average annual rate of growth in deposits between 1969 and 1997 was about 18 per cent, as compared with 9.3 per cent between 1951 and 1969. Aggregate deposits showed a sustained increase of 19.8 per cent during 1997-98 and 19.3 per cent during 1998-99. Nationalised banks accounted for about 80 per cent of the total aggregate deposits with banks. It is important to note that time deposits constitute the major part of aggregate deposits with banks. These were 85.4 per cent of aggregate deposits at the end of September 1999.

An all-round increase in bank deposits has been largely due to rising money supply in the economy. However, the expansion of bank offices and the attempts at deposit mobilisation by banks have also greatly helped in raising the volume of resources available to banks in the form of deposits from the public. It is true that the high rate of inflation in the post-nationalization years would cut the growth-rate in deposits by more than half, but a real average annual growth rate of 8 or 9 per cent is still very impressive.

Credit Expansion :

The credit policy of banks, as directed by the Reserve Bank, was directed towards promoting investment, aiding production and exports, and assisting the priority sectors and weaker sections of the society.

Bank credit (loans and advances together with bills purchased and discounted) of scheduled commercial banks increased from Rs. 3,599 crore to Rs. 3,65,435 crores between June 1969 and June 1999. Between 1969 and 1980 the average annual rate of increase in bank credit was around 18 per cent, as against 10.6 per cent between 1951 and 1969. Between 1980-81 and 1989-90 the average annual rate of increase was 16.8 per cent. On an average basis, expansion in bank credit between 1990-91 and 1996-97 was around 19 per cent but it varied widely from year to year. Expansion during 1998-99 was 13.8 per cent, which was smaller than the increase of 16.4 per cent in 1997-98.

There was a decline in advances made for food procurements, *i.e.*, food credit. The growth rate of non-food credit in 1998-99 (13.0 per cent) was also lower than that in 1997-98 (15.1 per cent). A large part of the bank credit is allocated to the non-food sector and during the year 1998-99 the non-food credit constituted as much as 90.3 per cent of total bank credit. A relatively lower rate of growth in bank credit in recent years is largely due to the fact that corporate entities have started raising large amount of funds from the capital market. Deceleration in industrial growth was also an important factor underlying the sluggish credit growth. Banks have restricted credit in the context of prudential norms. Weak banks, in particular, have become cautious with regard to lending for the fear of enlargement of non-performing assets (NPAs). The increase in the risk-adjusted yields on Government securities has had the effect of making investments in risk-free Government securities relatively more attractive.

Investment in Government securities by scheduled commercial banks increased from Rs. 1,055 crore in March 1969 to Rs. 16,776 crore in March 1985 and Rs. 2,58,367 crore in September 1999. This was in addition to investments in other approved securities. Bank's response was facilitated by the fact that Government securities which are risk-free were available at market related rates of interest in the auctions as well as under the Reserve Bank's open market operations.

Apart from lending credit to the non-food-segment of the commercial sector, the banks also invest their funds in various

financial papers including commercial papers, PSU bonds and the bonds floated by private companies.

Lending to Priority Sectors and Weaker Sections of the Society :

Apart from financing public food procurement and exports, commercial banks, both in the private sector and the public sector, have extended liberal credit facilities to the priority and neglected sectors of the economy which include agriculture, small-scale industries and other priority sectors comprising small borrowers such as road and water transport operators, retail traders and small businessmen, professional and self-employed persons, and persons desirous of receiving higher education. In June 1969, advances provided to the priority sectors were 14.6 per cent of net bank credit. With a view to enlarging the flow of bank-credit to neglected sectors, banks were advised by the Government that their priority sector lending should reach a level of not less than one-third (33.3 per cent) of their outstanding credit by March 1979.

The guidelines set out in March 1980 stipulated bank finance to the priority sectors to reach 40 per cent of their total advances by 1985. As a sub-target, it was prescribed to step up advances to agriculture to the level of 16 per cent by March 1983 and go beyond this level by 1985 so as to reach the level of 15 per cent as 'direct' advances. Under the latest revision, the overall stipulation of priority sector lending of 40 per cent of net bank credit remains unchanged. The share of, 'weaker sections' at 25 per cent of priority sector advances or 10 per cent of total advances also remains unchanged. As sub-targets, it has been decided to club the 'direct' and 'indirect' categories of advances for agriculture within the sub-target of 18 per cent for agricultural lending as a whole subject to the stipulation that 'indirect' agricultural lending should not exceed one-fourth of the total agricultural leading *i.e.*, 4.5 per cent of net bank credit. All advances to small-scale industries are treated as priority sector advances.

It is stipulated that each bank should earmark 40 per cent of total credit to small-scale industries to small units with investment in plant and machinery up to Rs. 5 lakh and other small units availing credit limits up to Rs. 5 lakh. Targets are laid down for

attaining credit-deposit ratios at rural and semi-urban branches, financing under Differential Rate of Interest (DRI) schemes. Integrated Rural Development Programme (IRDP), Self-Employment to Educated Unemployed Youth (SEEUY). Self-Employment Programme for Urban Poor (SEPUP), etc.

Private Sector banks are also required to fulfil targets applicable to public sector banks in respect of priority sector assistance and also for agriculture and allied activities. Foreign banks operating in India are required to achieve a target of 32 per cent of their net bank credit in lending to the priority sector with two specific sub-targets of 10 per cent for small scale industries and 12 per cent for exports.

The appreciable expansion achieved in the direction of lending to priority sectors is evidenced by the fact that scheduled commercial banks' advances to the priority sector increased from Rs. 505 crore to Rs. 18,407 crore between June 1969 and March 1985. Percentage of advances to priority sectors in total bank credit increased from 14.0 per cent in June 1969 to 39.9 per cent in March 1985, as against the target of 40 per cent of total bank credit to be reached by March 1985. Total priority sector advances of the public sector banks increased to Rs, 29,230 crore as at the end of June 1988, constituting 45.7 per cent of total net bank credit. In the subsequent years, the amount of priority sector advances increased in absolute terms, but it declined in terms of percentage. The priority sector advances constituted 44.6 per cent and 42.3 per cent of total net bank credit as at the end of June 1989 and June 1990, respectively, the percentage share in June 1991 and June 1992 was 40.9 per cent and 39.3 per cent, respectively. Advances to the priority sectors further declined to around 35 to 37 per cent in subsequent years.

Reforms introduced in the area of priority sector lending aimed at enlarging the definition of priority sector so as to include loans to traditional plantation crops, loans for housing up to Rs. 5 lakh, investments made by banks in special bonds of NABARD/SIDBI, and contributions to Rural Infrastructure Development Fund. Banks have an option to invest shortfall in priority sector lending in NABARD/SIDBI, thus exercising freedom not to lend to commercially unlivable activities.

The priority sector advances of public sector banks amounted to Rs. 1,07,200 crore and formed 43.5 percent of the net bank credit as on last Friday of March 1999, as against 41.8 per cent a year earlier. The priority sector advances of Indian private sector banks also improved from 40.9 per cent to 41.4 percent. The priority sector advances of foreign banks at 37.0 percent of net bank credit in March 1999 also exceeded the prescribed minimum of 32 per cent in their case. During the year 1998-99 the coverage of priority sector credit was widened to include advances to NBFCs for on lending to truck operators satisfying priority sector norms (owning up to 10 vehicles); advances upto Rs. 1 crore to Software industry, advances to food and agro based processing sector, lending to NBFCs or other financial institutions for on-lending to the tiny sector and investments in venture capital.

Out of the priority sector advances of public sector banks, as at the end of March 1999, the largest proportion is shared by small scale industries (39.8 per cent) followed by agriculture (37.4 per cent) and a group of other priority sectors (22.8 per cent). The advances for small-scale industries and agriculture as proportion of net bank credit constituted 17.3 per cent and 16.3 per cent respectively at end March 1999. In the case of private sector banks, the share of small scale industries constituted 18.9 per cent of net bank credit as against 9.5 per cent share of agriculture. As regards foreign banks operating in India, the export credit as a proportion to net bank credit constituted as high as 25 per cent (more than twice the target of 12 per cent). The advances provided to small-scale industries accounted for 11 per cent of their net bank credit.

Rural Credit :

The ruralisation of Indian commercial banking has meandered through many policy prescriptions. Rural branches of commercial banks constitute about 50 per cent of total branches. In addition to Cooperative banks, commercial banks and Regional Rural Banks (RRBs), sponsored by the scheduled commercial banks, provide multi-purpose and multi-term credit for agriculture and allied activities. As a result, both farmers and non-farmers in the rural sector have comparatively an easy access to the lending windows of the commercial banks.

The scheduled commercial banks supplement efforts of NABARD and the cooperative banking in extending credit facilities to the rural sector of the economy. Banking credit to rural sector includes priority sector advances as well as credit extended under various schemes.

The Rural Infrastructure Development Fund (RIDF) managed by NABARD has emerged as a popular and effective scheme for financing rural infrastructure projects. The corpus of these funds is contributed by the scheduled commercial banks to the extent of the short fall the banks may post for meeting the priority sector lending targets. NABARD's efforts towards increasing the access of the rural poor to formal banking services through promotion and credit linking of Self Help Groups of the rural poor, and other micro-finance initiatives gathered momentum since 1998-99.

Pursuant to the announcement made in the Union Budget for 1998-99, 'Kisan Credit Card' scheme was formulated. Cooperative banks, Regional Rural Banks and Commercial Banks together have issued more than 50 lakh cards and card-cum-pass books to the farmers by end-March 2000. NABARD and commercial banks have been asked to issue an additional 75 lakh Kisan Credit Cards by March 2001.

With a view to providing institutional mechanism for promoting rural savings as well as for providing credit for viable economic activities in the local areas, the Reserve Bank announced a set of guidelines in 1996 for setting up of Local Area Banks in the private sector. As on June 30, 1999, eight such banks were given approval in principle.

Credit to Export Sector :

The export sector has all along received high priority in the provision of bank credit. Under directions from Reserve Bank several measures have been introduced to ensure the availability of adequate and timely credit to the export sector. The terms of various export credit schemes have been liberalised from time to time. The Reserve Bank provides export credit refinance to scheduled commercial banks. Foreign banks in India treat export credit as priority sector advances.

Banks are required to lend 12 per cent of advances as export credit. Export credit as a percentage of net bank credit, however, declines to 10.6 percent in 1998-99 from 11.4 per cent in the previous year, reflecting decline in exports. The outstanding export credit of scheduled commercial banks amounted to Rs. 34,504 crore as on June 18, 1999, indicating an increase of Rs. 2,833 crore or 8.9 per cent over the same period in the corresponding year.

The interest rates charged on export credit were progressively reduced during 1997-98 and 1998-99 to step up the rate of growth of exports. During 1998-99 export credit refinance limits of banks showed a more than three-fold increase from Rs. 2,403 crore in March 1998 to Rs. 7,269 crore in March 1999.

Lead Bank Scheme :

The Lead Bank Scheme (LBS) was introduced by the Reserve Bank in December 1969 on the basis of the recommendations of a study group appointed by the National Credit Council under the chairmanship of the late Prof. D.R. Gadgil. The basic objective was one of orienting banking development in the country towards an "area approach" and thus ensuring that the developmental needs of all regions and all sections of the community are served by the banking system in conformity with national priorities. The administrative unit 'district' was taken as the nucleus of this approach and all the districts in the country were allotted among different banks in the public and private sectors. Each bank was expected to survey the potential for banking development in the allotted districts, to identify institutional and credit gaps and to take the initiative in endeavouring to fill them and thus intensively involve itself in the process of economic advancement of the districts concerned. The Lead bank does not have a monopoly over banking business in the districts allotted to it. However, it acts as the leader of all the other banks in those districts, works closely with them and the other financial institutions in the area and the Government Departments, and jointly sponsors the banking development of those districts so as to help in their overall economic development. The Lead Banks prepare district credit plans, but non-Lead banks have as much responsibility as the Lead Banks in promoting development

efforts in the districts concerned. Lead Banks undertake the formulation of District Credit Plans for their lead districts and also Annual Action Plans before the commencement of each year. The credit plan is a comprehensive plan indicating credit targets for institutional credit agencies in the district on a block-wise, sector-wise, scheme-wise and bank-wise basis. The Lead Bank Scheme covered 567 districts of the country at the end of March 1999.

The main focus of Lead Bank Scheme is to enhance the proportion of bank finance to priority sector. The scheme controls and coordinates the activities of banks and other development agencies in achieving the sectorial targets set on annual basis.

Innovations and Diversification of Business :

Commercial banks have been encouraged to diversify into fresh areas of business, *viz;* merchant banking, equipment leasing, venture capital, mutual funds, housing finance and other financial services. They have introduced innovative schemes of deposit mobilisation, providing consumer credit, issuing credit cards etc., Several banks have set up separate subsidiaries for the purpose. Two banks have set up subsidiaries to commence factoring services. Some banks have set up subsidiaries for undertaking primary/satellite dealership in Government securities market. Housing finance subsidiaries have also been set up by several banks. All such activities are termed as 'para banking activities'.

The Government Securities market in India has traditionally been narrow and captive with low coupon rates. Distributional investors such as banks and other institutions dominated the market to meet their statutory requirements. These banks/institutions had invested huge sums of money. However, there was no active secondary market in securities. The raising of coupon rates on Government securities, freeing of inter-bank call notice market from ceilings on interest rates, introduction of new instruments (like 182 days Treasury Bills, inter-bank participation's, Commercial Paper, Certificates of Deposit, etc.), where the rates of interest are not administered but determined by market forces, and such other liberalization's have been much helpful to commercial banks. To encourage bill culture, steps like lowering of bill

discounting rates, stipulation of norms for use of bills for credit purchases and credit sales etc., have been taken. Prudential norms for lending have been laid down for banks so as to reduce the risks for individual banks and enable them to grow on healthy lines.

Over the years, banks have been growing into broad-based financial service institutions. The innovations of Commercial banks indicate their adaptive skills and the vital role they have been playing in the process of development, spanning rural and urban, agricultural and non-agricultural and organized and unorganized sectors of the economy—each sector needing different approaches, skills and techniques. Here lies the real achievement of Commercial Banks in India.

Technological Development :

Information Technology and the communication Networking Systems have revolutionized the functioning of banks the world over. In India, it is only recently that the world of information technology preparedness has made inroad in the sphere of banking operations.

With regard to the payments and settlement systems, since the introduction of MICR cheques in the mid-eighties, the Reserve Bank has proceeded to make significant improvements with respect to their application of information technology. These include introduction of Electronic Funds Transfer (EFT), introduction of inter-bank electronic payments system, introduction of a clearing bank for extension of delivery versus payment mode of trading in Government securities, introduction of Automated Teller Machines (ATMs) by major banks and the putting in place of a Shared Payments Network Systems (SPNS) termed SWADHAN in Mumbai. The Reserve Bank has also operationalised the Very Small Aperture Terminal (VSAT) network to provide reliable communication backbone to the financial sector. The setting up of the *Indian Financial Network* (INFINET), based on satellite Communication using VSAT technology, at Hyderabad has facilitated consecutively within the financial sector. The Reserve Bank has made a pro-active effort in deciding to move towards a Real Time Gross Settlement (RTGS) system. The MICR cheque processing centers, in existence at the

four metros, have been extended to some more centers, out of 26 additional centers identified for the purpose. An improved processing system for MICR cheques commenced in August 1999. At the end of September 1998, 3668 branches were fully computerised and 6961 branches were partially computerised. To provide extended banking hours to the customers, many banks are going in for Shared Payment Network System (SPNS), installation of Automated Teller Machines (ATMS) and Cash Dispensers. The number of ATMS had grown to 100 in 1998-99. These apart, many banks are providing services like tele banking and Internet banking services and have become members of the Society For World-Wide Inter-Bank Financial Telecommunications (SWIFT). Such reliance on SWIFT is essential if banks dealing in foreign exchange are to access international markets in a cost effective manner.

Prudential Norms :

In trying to improve the financial health and creditability of banks, a major step that has been undertaken is to introduce internationally accepted prudential norms relating to income recognition, asset classification, provisioning and capital adequacy. These have already been discussed earlier under 'financial reforms'. As regards Capital to Risk weighted Assets Ratio (CRAR), 26 of the 27 public sector banks have already achieved 9 per cent CRAR at the end of March 1999. There were 14 banks with CRAR above 10 per cent and 4 banks with CRAR between 8 and 10 per cent. Similarly majority of the Indian private Sector banks and foreign banks in Indian had CRAR above 10 per cent at the end of March 1999.

Important Problems and Failures :

There is no denying the fact that banking has developed in a very striking manner after nationalization of major banks in 1969. But the performance of banks in certain directions has not been very satisfactory. Some of the main shortcomings are indicated below:

1. *Regional Disparities :* The geographical spread of banking since nationalization has been so spectacular that the average population served per bank office has significantly declined from

65,000 in June 1969 to 15,000 in June 1999. However, notwithstanding the phenomenal branch expansion, the regional imbalances in respect of banking infrastructure still persist. The average population served per bank office is still higher than the national average in the States of Assam, Bihar, Madhya Pradesh, Manipur, Orissa, Tripura, Uttar Pradesh and West Bengal. North-Eastern, Eastern and Central regions are lagging behind other regions in the matter of provision of banking facilities. There is a great degree of regional variations so far as credit deployment is concerned. The statistical tables relating to banks released by the RBI disclose that the credit-deposit ratio in most of the States are below the all-India level, indicating that deposits mobilised in these States are less utilized for advancing loans in those States.

The credit-deposit ratio of scheduled commercial banks both as per sanction was 55.5 per cent at end-March 1999. The ratio exceeded the all India level in Southern region (68.6 per cent) Western region (65.9 per cent) and 57.0 per cent in the Northern region. The North-Eastern region had the lowest (28.0 per cent) ratio. It was 37.4 per cent in the Eastern region, 37.0 per cent in the Central region. The C-D ratio was highest at 93.0 for Tamil Nadu followed by Maharashtra (72.8 per cent) and as low as 14.1 per cent in Arunachal Pradesh and 15.7 per cent in Nagaland.

2. Decline in Credit-Deposit-Ratio : The C-D ratio provides an indication of the extent of credit deployment for every unit of resource raised. Total credit extended by Scheduled Commercial banks showed an increase of around 12 times between 1969 and 1984. The C-D ratio, however, fell from 77.4 per cent in 1969 to 70.7 per cent by 1984. Subsequently it declined to 60.7 per cent by 1990 and then to 55.6 per cent by 1995. The C-D ratios of scheduled commercial banks in recent years show a declining trend. In terms of bank group, over the period from March 1998 to March 1999, while the ratio has remained at 45.3 per cent for nationalised banks, it has witnessed a significant decline for the State Bank Group from 56.1 per cent to 49.5 per cent.

3. Imperfect Sectoral Development of Credit : An analysis of the sectoral deployment of bank credit reveals that industry and

trade account for a large share of bank credit. This is so in spite of Government's declared policy of preference to priority sectors and rural development. With growing funds in command, banks (within available flexibility) want to deploy funds in higher volume wholesale lending opportunities. A sizeable part of bank credit is deployed for financing industries, facilitating temporary build-up of inventories and for aiding general investment activity. In their eagerness to capture clients, sometimes the risk-supervision element is not adequately looked after. As a result, quality of traditional portfolio has deteriorated and industrial sickness is seriously constraining. The economic units may not necessarily avail of bank financing only through the conventional form of credit. They could as well gain resources from banks from the sale of their equities or debentures or bonds or commercial papers.

The flow of bank-credit to the priority sectors has declined. The fact, however, is that a major part of loans for agriculture are given to big farmers, while small and marginal farmers remain ignored. Similarly, bulk of the amount lent to small-scale industries has been pre-empted by rich-managed small and ancillary industries. The professionals and self-employed also include doctors, architects and chartered accountants with an urban and prosperous style of living. Thus, really small and poor people are left with no alternative but to suffer privations, despite the fact that credit policy is supposed to have shifted in their favour. In view of the banks' reluctant attitude towards priority sector lending mainly on account of poor recovery position adding to their non-performing assets (NPAs), definition of priority sector has been changed so as to provide opportunity to banks to make loans to relatively bigger borrowers on commercially viable terms. The banks have an option to invest short fall in priority sector lending in special bonds of SIDBI, NABARD etc. and contributions to RIDF.

The introduction of prudential norms has induced the banks to resort to what is popularly referred to as 'Credit Rationing' and invest more in safer directions such as Government securities. The banks' investments in approved securities other than that in government and marketable instruments has increased the flow of banks' funds to big borrowers in the private sector.

4. Non-Performing Assets : An asset is classified as Non-Performing Asset (NPA) when it gets classified as 'Sub-Standard' and the bank stops recognising income on accrual basis. The quantum of non-performing assets (NPAs) as a percentage of advances is one the critical indicators of the quality of a bank's loan portfolio and hence of its overall health. An analysis of NPAs of different bank groups indicate that public sector banks (PSBs) hold larger share of NPAs. As at end March 1999, the level of gross NPAs to gross advances stood at 15.9 per cent. Net NPAs to net advances were 8.1 per cent. Gross NPAs of all private banks was 10.4 per cent and net NPAs to net advances amounted to 6.9 per cent showing an increase as compared to previous year. NPAs of foreign banks also increased during the year, gross NPAs being 7.0 per cent and net NPAs at 2.0 per cent was the lowest among various bank groups.

During the year 1998-99, number of PSBs with net NPAs up to 10 per cent was 18 and the number of banks with net NPAs in the range of 10 per cent to 20 per cent was 8 with one bank continuing to show NPAs above 20 per cent. The number of old private sector banks with the net NPAs below 10 percent was 17, between 10 per cent to 20 per cent the number was 5 and those above 20 per cent were 3. Net NPAs of all the new private sector banks were up to 10 per cent only. In the case of foreign banks, those with net NPAs up to 10 per cent were 27 and those above 20 per cent stood at 3. 11 of them were with net NPAs ranging between 10 to 20 per cent.

The economic survey for 1999-2000 stated that out of 21,781 cases involving a total sum of Rs. 17,921 crore transferred to the Debt Recovery Tribunals only 17.3 per cent *i.e.*, 3774 cases were solved recovering 10 per cent of the locked up amount. The net NPAs of the scheduled commercial banks as a whole increased from 7.3 per cent of their net advances in 1997-98, to 7.9 per cent in 1998-99. The Second Narasimham Committee (1998) had underlined the need to reduce the average level of net NPAs for all banks to 3 per cent by 2002 and to zero for banks with international presence. The recovery of NPAs was the bane of Indian banking. The huge portfolio of NPAs highlighted the need for a proper credit appraisal

as well as regular monitoring and follow up of the loans sanctioned. Debt recovery system needs to be strengthened.

5. **Unsatisfactory Progress in Deposit Mobilisation** : The aggregate deposits of banks have increased. However, keeping in view the rapid rise in money supply and money incomes and the large expansion of bank offices, the progress cannot be considered as satisfactory. The performance of rural offices particularly has been most unsatisfactory. Relatively lower yield on bank deposits compared to several other instruments of investment has led to the diversion of funds to the corporate sector or to the national savings organisation of the Government. The preferences of the households are shifting towards financial instruments promising higher incomes or higher capital gains. The present state of affairs establishes the need for a long-term perspective policy in respect of resource-mobilisation by banks.

6. **Inefficient Management** : The success of a bank depends on many factors, but none of them would be effective unless the top management provides leadership and vision and comes to grip with these problems. The Chairman is a powerful force in the management of a bank, but very often he does not get full support from the Board of Directors. One reason for this is that unlike in many organizations, the Directors do not owe their selection, appointments or continuance to the Chairman. It does not really help to build up a sound team of an efficient organisation. Generally there is a direct conflict among directors over the issue whether profitability is the objective or social service. They have not been able to come to grip with the following major problems :

- (a) The relationship between and the relative amount of profitability and social service.
- (b) Lending and investment policies with a view to achieving balance between profitability and service, between professional lending and lending to develop economic strength of weaker areas or sections,
- (c) To motivate the middle management and the workmen employees in order to reduce the costs and increase the productivity.

- (d) To develop a spirit of joint or team decisions in order to plan for growth and development and to implement the plans for diversification.

It is also alleged that the present structure of public sector banks is wasteful and facilitates all sorts of malpractice's in the banking operations. Narasimhan Committee on Banking Reforms (1998) has made recommendations for restructuring of banks and improvement in management.

7. Inefficient Customer Service : There is much to be desired in the working of banks with regard to the tone, caliber and quality of banking services provided to the customers. The main causes of dissatisfaction with banks are three : (i) delays at the counter, in correspondence and in bank loans and services; (ii) indifference and carelessness of banks staff towards the needs of the customers and public regarding outstation collections, local clearings, pass books or statements and mistakes in accounting ; and the helplessness of the management about it; and (in) frequent dislocation of work in branches and clearing houses due to strikes, agitation's and go-slow campaigns.

The Working Group on Customer Service in Banks appointed by the Government of India in March 1975 identified three critical service areas : (a) deposit accounts, remittance and collections, enactment of cheques, issuance of receipts, statement of accounts, collection of cheques and bills, and remittances including issue and enactment of draft; (b) loans to small borrowers ; and (c) staff attitudes. The Committee on Customer Service appointed by the Reserve Bank under the Chairman ship of Shri M.N. Goiporia, submitted its report in December 1991. The Committee made wide-ranging recommendations to bring about an improvement in customer service. After examining the recommendations, the Reserve Bank issued detailed guidelines to the banks relating to (i) advancing of working hours of staff; (ii) extensions of business hours; (iii) introduction of bank order in various denominations; (iv) acceptance of notes of small denomination; (v) exchange, of mutilated and soiled notes; (vi) immediate credit to local cheques up to Rs. 5,000 and (vii) payment of interest on delayed collection of outstation instruments.

Banks have, however, mostly ignored these guidelines. Bank managers and senior executives argue that much improvement can be made if the *staff problem* is solved. The staff unions, on the other hand, hold that it is the weak management's that are unable to manage the banks, and utilize the staff properly, rather than the staff being unwilling to, or obstructing work. Actually speaking, all that is needed is better discipline, formulation and enforcement of proper rules and code of conduct, and proper selection and training of staff at all levels.

The Banking Ombudsman Scheme, 1995, has been introduced for expeditious and inexpensive resolution of customer complaints about the deficiencies in banking services. It has, however, been of limited use and effectiveness because of limited powers of Ombudsmen.

8. *Slow Progress of Lead Bank Scheme* : A close study of the working of the Lead Bank Scheme shows that the progress in this regard has been far from satisfactory in all districts. The initial district surveys took more than twice the scheduled time. The progress of the second and more difficult phase, consisting of the formulation and identification of area development programme has been very slow. The lead banks have prepared district credit plans to push up the growth rate, but the schemes have not been successfully implemented. The "area approach" that was the theoretical basis of the scheme, assumed an unrealistically large reach for the banks. The lead banks constituted district consultative committees which have provided a forum for bankers and administrators to discuss the various problems of the districts and to take remedial measures. However, the banks could not gainfully make use of the committees' decisions for want of effective follow up actions on their own part and that of the administrators.

9. *Declining Profitability of Banks* : Profit in a commercial organisation is an index of efficiency and sound management. The working results of scheduled commercial banks as available in their published profit and loss accounts for different years do not show any uniform trend. It is, however, certain that profitability of operations of the banks is under great strain. In the absence of close

supervision over proper utilisation of loans, recovery of loans has been adversely affected resulting into mounting over dues. As a result, provision for bad and doubtful debts becomes the first charge on the profits of a bank. The high level of the NPAs of banks has been a matter of concern that has resulted in declining profitability of banks.

Of course, banking is a service; but it has to be a business at the same time. Reasonable profit has got to be earned to provide for bad and doubtful debts, create reserves to meet unforeseen liabilities and pay dividends. More than these, banks are very sensitive credit organizations and public image thereof and public confidence therein have to be sustained. Therefore, they should operate the funds entrusted to their care in such a way as not to undermine their stability. They have to emerge as 'viable' and not subsidised instruments of growth.

The experts' committee setup by the RBI in April 1976, headed by Shri J.C. Luther, stressed the need for a drastic cut in expenses through cost control and other methods and to consider an increase in earnings of the banks so as to prevent the banking system from becoming a drag on the economy. The Indian banking system has actually reached a stage where it is necessary to make a determined effort to ensure the continuance of its growth without jeopardizing its stability.

Profits of commercial banks have come under pressure mainly due to rise in interest expended, deceleration in non-interest income and increase in provisions' and contingencies. The financial performance of scheduled commercial banks shows that their operating profits (net profits plus provisions and contingencies) as a ratio of total assets were 1.47 per cent in 1998-99 as against 1.84 per cent during the previous year. The decline was witnessed in all bank groups. The ratio of operating profits to total assets in the case of public sector bank declined to 1.37 per cent in 1998-99 as compared to 1.58 per cent in 1997-98. The ratio of net profits (Income minus expenditure) also declined from 0.77 per cent in 1997-98 to 0.42 per cent in 1998-99. Among public sector banks the decline in operating and net profits was more pronounced in the case of State Bank of India and its Associate Banks.

Net interest income (spread) of scheduled banks (*i.e.* interest income *minus* interest expended) was 2.79 in 1998-99. It was 2.81 in the case of public sector banks. Among the components of expenditure, interest expenditure was 6.21 per cent of total assets of public sector banks in 1998-99. Inter-mediation cost (other operating expenses) as a percentage of total assets was 2.65. For public sector banks, nearly three-fourth of their inter-mediation cost consists of wage bill. An improvement in spread and a decline in inter-mediation cost will result into a high net profit ratio. Capital adequacy ratio reflecting the financial viability of banks was lower at 11.2 percent in 1998-99 compared to 11.5 per cent in 1997-98.

10. Irregularities and Malpractice's : It is an extremely sad affair that the 'securities scam' which rocked the nation in 1991 -92 was largely an outcome of irregularities committed by the banks and financial institutions. A Committee with Shri R. Janakiraman, Deputy Governor of the Reserve Bank, was set up on April 30, 1992, to investigate into the matter. The sixth report which was final report was presented in April 1993. The reports contain detailed findings in respect of 32 banks and institutions where the irregularities were of a serious nature.

The findings reiterate the nexus between brokers and banks and the fact that the banks and their subsidiaries covered in the reports continually sought to circumvent the Reserve Bank's guidelines on Portfolio Management Services, so as to enable brokers and financial companies access large funds for use in the stock market for huge profits.

The reports identified following four key factors in the perpetration of irregularities :

- (i) improper and indiscriminate use of Bankers Receipts;
- (ii) brokers increasingly dealing on their own accounts and taking positions;
- (iii) banks' failure to periodically reconcile investments; and
- (iv) complete breakdown of internal control system in a number of banks.

The Committee observed that as a consequence of these irregularities, the investment portfolios of banks were fragile and weak. The Committee's final estimate of gross problem exposure of banks was of the order of Rs. 4,024 crore. The Committee pointed out the existence of weak internal control systems in banks, and weaknesses in the supervisory mechanism. The Committee observed that the irregularities could possibly have been detected earlier if there had been greater coordination among the different controlling agencies.

The Janakiraman Committee had made recommendations for taking a series of steps so that remedial action was taken to introduce proper control system, strengthen monitoring and remove lacunae in the existing system and procedures so as to prevent recurrence of similar lapses in future.

The Board for Financial Supervision (BFS) was set up under the aegis of the RBI. But it has not been functioning effectively. The weak supervision has hardly evoked any satisfactory response with respect to corrective and remedial measures. The Working Group to Review the System of on-site Supervision Over Banks (Chairman : Shri S. Padmanabhan) in its report submitted in November 1995 had recommended far reaching changes in bank inspections, introduction of a rating methodology for the banks and a focused approach to follow-up on inspection reports, and supervisory intervention.

During the year 1998-99 (July-March), commercial banks reported 1,974 cases of frauds involving an amount of Rs. 606.21 crore. In addition, 97 cases of robberies involving an amount of Rs. 6.13 crore were reported by public sector banks. While it is well recognised that frauds could occur in all types of economies, regulated or deregulated, it is imperative that each bank puts in place a resilient internal control system to detect incipient frauds, and regulatory and supervisory mechanisms are honed up to pick up the early warning signals. Both on-site and off-site supervision system are necessary for capturing such signals.

Concluding Observations :

Consumers of banking services are getting increasingly agile, enlightened, cost and quality conscious, exerting in the process

pressures for effective competition in the banking industry. Competition should not be construed to mean that banks cannot enter strategic alliances. By forging strategic alliances, without undermining competition, banks would be better enabled to face greater risks on account of deregulation of financial markets and the trend towards globalization. Public sector banks dominating the market may be given greater autonomy in the conduct of their operations. In the process, they could be made genuinely accountable than at present. This issue needs to be part of the agenda of the second phase of banking sector reforms. Narasmiham Committee's report submitted in April 1998, contains several suggestions for banking reforms. It deserves a serious consideration.

In the period ahead attempts must be made to consolidate the gains of earlier reform measures. In this context attention needs to be focussed on factors which enhance competitiveness and efficiency of the banking sector. This is essential both to broaden and deepen the sector and enhance its role in economic development.

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CHAPTER



REGIONAL RURAL BANKS

The Government of India had constituted a Working Group on July 1, 1975 to study, in depth, the problem of devising alternative agencies to give institutional credit to rural people. Regional Rural Banks (RRBs) were set up following the recommendations of the Working Group. The President issued an Ordinance on September 26, 1975 to enable the Government to make arrangements for the establishment of RRBs. The Ordinance was subsequently replaced by the Regional Rural Banks Act, 1976.

The first five RRBs or Gramin Banks were established on October 2, 1975. By the end of June 1984, 162 such banks had been established covering 286 districts. It was planned to set up a total of 170 RRBs in the country during the Sixth Plan period (1980-85) benefiting 270 districts. There were 196 RRBs at the end of June 1999 and the number of their branches was 14,469.

The RRB is basically a scheduled commercial bank and is authorised to carry on and transact the business of banking as defined in Section 5 (b) of the Banking Regulation Act, 1949 and may also engage in other business specified in Section 6 (1) of the said Act. The role and the functions of an RRB are, however, different from those of other commercial banks in many respects. The main

objective of setting up the RRBs is to provide credit and other facilities especially to the small and marginal farmers, agricultural labourers, artisans, small entrepreneurs and persons of small means engaged in productive activities in rural areas. The area of operation of an RRB is limited to particular regions consisting of one or more districts in a State, They may establish their branches in their respective areas of operation. Each RRB is sponsored by a commercial bank. The sponsoring banks provide assistance to the RRBs in several ways, *viz*; subscription to their share capital, provision of such managerial and financial assistance as may be mutually agreed upon and help in the recruitment and training of personnel during the initial period of their functioning. The RRBs, along with other financing agencies, participate in the preparation and implementation of District Credit Plans.

The authorised capital of each RRB was initially Rs. 1 crore and the issued capital was Rs. 25 lakhs. Of the issued capital, 50 per cent was subscribed by Government and 35 per cent by the sponsoring bank. The RRB (Amendment) Act, 1987, which came into force on Sept. 28, 1988, enhanced the authorised capital of RRBs to Rs. 5 crores and paid-up share capital to Rs. 1 crore.

The management of the RRB is vested in a nine-member board headed by a Chairman appointed by the Government of India. The Central Government, the sponsoring bank and the concerned State Government nominate three, and two members, respectively to the board. While a RRB is empowered to appoint officers and other employees, their salary structure was prescribed by the central government, having regard to the salary structure of the employees of the state government and local authorities of comparable level and status in the area of operation of the bank. The RRBs have been directed to follow simplified accounting and operational procedures in accordance with the suggestions of the Committee constituted for the purpose by the Reserve Bank of India in 1976. The lending rates of the RRBs are not higher than the prevailing lending rates of cooperative societies in the State concerned.

The RRBs enjoyed a privileged position with regard to Reserve Bank's assistance and concessions. Consequent upon the

establishment of the National Bank for Agriculture and Rural Development (NABARD) in July 1982, it has taken over from the Reserve Bank its refinancing work in relation to the RRBs and the State Cooperative banks. NABARD is empowered to provide to them short-term refinance assistance for periods not exceeding 18 months. It can grant medium-term loans for periods extending from 18 months to 7 years. It is empowered to provide by way of refinance assistance, long-term loans extending up to a maximum period of 25 years including the period of rescheduling of such loans.

The RRBs are needed to maintain cash reserves with the Reserve Bank at the rate of only 3 per cent of their total demand and time liabilities, as against a higher percentage applicable to other scheduled commercial banks. The statutory liquid assets required to be maintained by the RRBs have been fixed at 25 per cent. The balances maintained by them in current account with any of the nationalised banks (and not only with the State Bank of India) are deemed to be cash for the purpose of compliance with the requirements of statutory liquidity ratio. An RRB is deemed to be a cooperative society for the purpose of Income-tax Act, 1961, It was not liable to pay tax under the Interest Tax Act, 1974.

As the position stood at the end of March 1999, the deposits and advances of 196 RRBs aggregated to Rs 25,428 crore and Rs. 11,016 crore respectively. Purpose-wise distribution of credit of RRBs reveals that as on March 31, 1998 the non-agricultural advances constituted a larger share of 55.6 per cent, whole the agricultural advances accounted for 44.4 per cent of the total advances. A significant proportion of agricultural loans is in the form of short-term crop loans.

As part of the endeavour to create a level playing field in respect of priority sector credit dispensation effective April 1, 1997, advances of RRBs to priority sector have been placed on par with commercial banks at 40 per cent of outstanding advances. Out of this, advances to weaker sections of society should be 25 per cent (10 per cent of total outstanding advances).

The performance of the RRBs has varied from region to region. While some of them have demonstrated their capability to serve the

purpose for which they were established; the efficiency and viability of majority of RRBs has been under considerable strain. Out of the 177 reporting RRBs, during 1998-99, 132 recorded profits as compared to 109 in 1997-98. Overall the net profit ratio of 177 reporting RRBs in 1998-99 was 0.70 per cent. The spread (net interest income) of RRBs was 3.23 per cent in 1998-99. The increase in profitability of RRBs can be attributed *inter alia* to both the decline in the ratio of inter-mediation cost (*i.e.*, operating expenses) to total assets and an increase in the spread (*i.e.*, net interest income).

RRBs have shown better performance in recovery of loans. The asset quality of RRBs has also shown significant improvements in recent years. In the total loans, the share of standard assets has shown increase from 56.9 per cent as at end March 1996 to 63.2 per cent asset end March 1997 and then to 67.2 per cent as at end March 1998. The share of non-performing assets concomitantly declined from 43.1 per cent to 36.8 per cent and then to 32.8 per cent over the same period.

In August 1976, the RBI constituted a Working Group (Kamath Working Group) to study the problems arising out of the adoption of multi-agency approach in agricultural financing and make appropriate recommendations. In June 1977 another committee (Dantwala Committee) was set up by the RBI to review the working of RRBs and make suitable recommendations. It was very well recognised that the RRBs were to play a vital role in the rural credit delivery system under a multiagency approach. Nothing substantial could, however, be done to solve their problems of operational bottlenecks, heavy over dues and the overhang of large losses.

NABARD has been monitoring on a quarterly basis the working of RRBs in relation to important parameters such as productivity, cash management, advances portfolio and recovery performance and advising them about necessary remedial status. On December 22, 1993, the Reserve Bank in consultation with the Government of India and NABARD announced a package of short-term measures of immediate relevance to RRBs. These include: (i) freeing RRBs whose disbursements were below Rs. 2 crore during 1992-93 from their service area obligations; (ii) increasing their non-target group

financing from 40 per cent to 60 per cent of fresh loans; (iii) allowing them to relocate the existing loss making branches at new places like mandi, agricultural produce centers at block/district headquarters; (iv) giving them freedom to open extension counters; and (v) upgrading and deepening the range of their activities to cover non-fund business such as remittance and discount facilities.

As enunciated in the Union Budget, 49 of the 196 RRBs were taken up during 2008-2009 for comprehensive restructuring and cleaning up their balance sheets and infusion of fresh capital. The modalities of restructuring as also the associated financial support that was required was worked out by Bhandari Committee.

To strengthen the capital base of RRBs, budgetary allocations have been made in the Union Budgets since 1994-95. The budgetary allocation for recapitalization were reduced from Rs. 400 crore during 1997-98 to Rs. 152.65 crore during 1998-99. However, the decline in the budgetary allocation was offset by the provision of additional equity support aggregating to Rs. 305.30 crore in 1998-99. The Union Budget for 1999-2000 made a provision of Rs. 160 crore for recapitalization of RRBs. Some RRBs were identified as eligible, based on certain criteria, for fresh infusion of funds under different phases of recapitalization process. With the infusion of capital under Phase V in 1998-99, 175 of the total 196 RRBs stood fully/partially recapitalised while 2 RRBs were not in need of recapitalization support. This left only 19 RRBs outside the ambit of the recapitalization programme.

On September 29, 1995, RRBs were advised to adopt income recognition and asset classification norms for the year 1995-96 and provisioning norms from the year 1996-97 onwards. RRBs' interest rates on advances were deregulated from August 26, 1996. Further initiatives, during 1996-97, included liberal branch licensing, rationalisation of guidelines in regard to investment avenues for surplus funds and shift from the Target Group - Non-Target Group Pattern to a prescription of a priority sector target from the year 1997-98. Kisan Credit Cards are being introduced in the RRBs to facilitate the provision of credit to farmers. RRBs have been encouraged to adopt self help groups for channeling credit to the poor on a sustainable basis.

The idea that the banking system can divert resources to meet the credit needs of the poor and under-privileged and at the same time run in accordance with commercial criteria of viability and profitability is evidently quixotic. The fact is that the rural scene continues to be dominated by the bigger landlord and the rich farmer who monopolizes existing credit sources and clamour for more. Only radical land reform can break the present strangle-hold of rural vested interests and thus change the present situation. Without thorough-going land reforms, the RRBs cannot be expected to have any perceptible impact on the rural financial scene for a long time to come.

Foreign Banks–Business in India :

Foreign banks in India are a distinct class. These banks are foreign in origin and have their head offices located outside India. Foreign banks are also called 'Exchange Banks' or 'Foreign Exchange Banks', because their main business is the financing of India's foreign trade. As a matter of fact, these banks were established in India mainly with this object in view. But they gradually entered in the field of internal trade and started competing with Indian joint stock banks in attracting deposits of all kinds, discounting bills of exchange and making advances to trade and industry. However, the financing of foreign trade still remains their main field of operation.

In recent years, the Indian commercial banks have made commendable progress in opening their branches abroad, expanding their business and in the provision of financial assistance and banking services to the foreign trade of the country. Still a considerable volume of foreign exchange business is in the hands of the exchange banks.

In July 1969, when the major Indian banks were nationalised, the foreign banks were exempted though some of them (*e.g.*, National and Grindlays Bank, First National City Bank and Chartered Bank) had their deposits exceeding Rs. 50 crores each. The major reasons for excluding foreign banks from nationalization were given as follows : "Foreign banks are part of a world-wide organisation and this enables them to give certain special facilities and service to

exporters and importers. For this type of service Indian banks do not have adequate network of branches abroad. Foreign banks have an intimate knowledge of parties in other countries on whom export bills are drawn by Indian customers. Foreign banks thus have a distinctive part to play in advancing foreign currency loans and administering them on behalf of their parent office, rendering service to tourists and in the spreading of information about business opportunities in India and in other countries in which they operate”.

At the time of nationalization of major banks in July 1969, there were 15 foreign banks working in India. Their number declined to 14 with effect from July 1, 1971 and to 13 with effect from October 1972. In November 1974, Sonali Bank of Bangladesh opened its office in India, thus raising the number of foreign banks in India to 14. Subsequently the number declined to 12. Of these 4 were British, 3 were from the U.S.A., 2 from Japan and the other 3 were from France, Netherlands and Bangladesh. During 1980, three new foreign banks, the European Asian Bank of Hamburg and the Emirates Commercial Bank Ltd., of Abu Dhabi and Bank of Oman of Dubai were permitted to open branches in India, thus raising the number to 15. INDOSUEZ Bank of France opened its first branch in 1981.

Bank of Credit and Commerce International, (Cayman Island), opened its first branch in 1982 and Bank of Nova Scotia (Canada) opened its first branch in 1984 by up-grading their representative offices in Mumbai. During 1988-89, three banks, *viz.*, Barclays Bank (U.K.), Sanwa Bank (Japan) and Bank for Foreign Economic Affairs of USSR were granted licenses to open a branch each. Deutsche Bank opened one more branch and Credit Lyonnais upgraded its representative office into a branch. During 1990-91, licenses were issued to four foreign banks to open branches in India. Sanwa Bank Ltd., and Barclays Bank opened their maiden branches by upgradation of their representative offices. At the end of June 1993, the number of Indian branches of 24 foreign banks stood at 141 in addition to 24 representative offices. More foreign banks opened their branches in India in the subsequent years. Their number increased significantly during 1995-96 and 1996-97.

During the year 1996-97 the number of foreign banks operating in India increased from 31 to 41 and that of branches from 161 to 180. One more foreign bank was opened during 1997-98. During the year 1998-99, 3 foreign banks opened their branches in India but one foreign bank stopped doing business in India. At the end of June 1999, the number of foreign banks operating in India was 44 and the number of their branches was 180. Grindlays Banks has the largest number of branches in India. It is followed by Chartered Bank, another British bank. These offices have been opened mostly at metropolitan centers and port towns.

Foreign banks operating in India are scheduled commercial banks. Foreign banks constituted 8 per cent of total assets in the banking sector in India in March 1999. Their operating profits and net profits as percentage to total assets were 2.53 and 0.90 respectively in 1998-99. The operating profits were far above the banking industry's average. The inter-mediation cost of foreign banks in 1998-99 (3.37 per cent) was higher than the overall average for banking industry (2.65 per cent). But the share of wage bill in inter-mediation cost was only 30 per cent as the wage bill was only 1 per cent of total assets. Foreign banks generally have a higher expenditure on technology. The net interest income (spread) of foreign banks was 3.47 per cent in 1998-99 which was the highest in the banking industry.

The gross NPAs of foreign banks to total advances were 7.0 per cent at the end of March 1999. Net NPAs to net advances at 2.0 per cent was the lowest among various bank groups.

The foreign banks have increased the shares of their deposits and outstanding credit in total deposits and outstanding credit of all scheduled commercial banks over time. This is the result of their working in a somewhat different way. Some of their important features are given below :

- (i) Merchant banking, securitisation of debts, off-balance sheet financing, portfolio management — all these are practices in which foreign banks have an edge over their Indian counterparts. This is partly because they have better instituted the expertise and the system to deal with such transactions than Indian banks.

- (ii) Their deposits cost them less compared to Indian banks. Vast amounts are held by them in their non-costing current accounts, which they are able to invest profitably.
- (iii) Foreign banks have been shrewd enough to undertake “non-fund” business on a fairly substantial scale. Under the non-fund business is included the issue of performance and other guarantees to government departments, customs and excise and for execution of overseas contracts. Also issuance of Letters of Credit for imports, advising of Letters of Credit to exporters, co-acceptances, syndication of international loans and public floatation of equities and debentures are included in non-fund business.
- (iv) The ratio of bills purchased or discounted to total advances is higher in the case of foreign banks as compared to Indian banks. The ratio of term loans to total advances is less than that in the case of Indian banks. There is, therefore, a higher spread, and also liquidity and quick turnover of invisible funds.
- (v) Foreign banks accept funds under the “funds management schemes”. These funds are not considered deposits and the banks have not to maintain statutory CRR and SLR on them.
- (vi) The merchant banking divisions of several foreign banks have been full of activity. Besides earning management fees, the interest earned on float funds has contributed in a major way to their profits.
- (vii) Several foreign banks have now opened divisions like technology funds and mutual funds. These are supposed to provide venture capital for new and fledgling companies to expand, modernize and diversify.
- (viii) Foreign banks have played and continue to play the role of canalising agents for foreign currency credits for major projects. They have also an edge over their Indian counterparts in mobilising funds from non-resident Indians abroad.

- (ix) They provide services to hedge against instability of rates by booking forward contracts.

The working of foreign banks in India has not been free from criticisms. The past history and conduct of foreign banks have been largely responsible for these criticisms. The Indian banks criticise the foreign banks for the competition which they have to face with them in financing not only foreign trade but also in internal trade, deposit mobilisation and provision of banking services. The complaints raised by the Indian clients of foreign banks relate to the preferential treatment given to foreign firms as against the Indian firms in several ways.

Some of the foreign banks were seriously involved in irregular and undesirable activities leading to 'securities scam'. They conducted their funds-management operations in gross violation and with utter disregard of instructions and guidelines issued by the Reserve Bank from time to time. Janakiraman Committee indicated serious deficiencies in the functioning of the banks involved in it.

Foreign banks no longer enjoy the monopoly of financing foreign trade. They are facing keener competition in foreign trade from Indian banks. Their working has been strictly regulated under the Banking Regulation Act, keeping in view the complaints raised by the Indian banks and the Indian businessmen dealing with the foreign banks. The Banking Regulation Act, 1949, contains a number of provisions especially applicable to foreign banks. The Reserve Bank permits expansion of a foreign bank only where it is found necessary to render more efficient service to Indian customers in financing foreign trade and tourism. The following new policy measures were introduced in foreign banking sector by the Reserve Bank of India in recent years :

1. For opening branch of a foreign bank in India, an initial capital of Rs. 15 crore in foreign exchange was prescribed. Assigned capital requirement for foreign banks opening their first branch in India was raised from Rs. 15 crore to US \$ 25 million in November 1991. However, on a review of the position on June 8, 1993 it was felt that the capital

requirement could be reduced to US \$ 10 million for the first branch which would be increased to US \$ 20 million when the second branch is permitted and to US \$ 25 million when the third branch is allowed.

2. Foreign banks were required to retain in India with effect from April 1, 1993, capital funds equivalent to 8 per cent of the risk-weighted assets. All the foreign banks have exceeded the minimum capital adequacy ratio (CRAR). During 1996-99, 14 foreign banks had CRAR between 8-10 per cent while 24 had above 10 per cent.
3. They are required to comply with the prudential norms relating to asset classification, income recognition and provisioning.
4. Foreign banks are required to constitute Local Advisory Boards whose constitution generally conforms to that of the Boards of Indian Banks.
5. Foreign banks were required to achieve priority sector lending target of 10 per cent of their net credit by end March 1989, 12 per cent by March 1990 and 15 per cent by March 1992. Their actual achievement was only 7.9 percent as at the end of March 1992 which was lower than even the ratio of 9.45 per cent attained at the end of March 1991. Foreign banks were, therefore, advised in April 1993 to reach the target of 15 per cent by June 1993, failing which they were required to make good the shortfall by placing a deposit of an equivalent amount with SIDBI at a rate of interest of 10 per cent per annum.

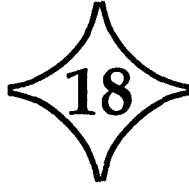
In order to align the priority sector lendings of foreign banks with that of Indian banks, the target of priority sector lendings was raised from 15 per cent to 32 per cent of their net bank credit inclusive of two sub-targets of 10 per cent each in respect of advance for small scale industries and the export sector to be achieved by the end of March 1994. The stipulated share of exports sector was subsequently raised to 12 per cent. The Reserve Bank stipulated that foreign banks could make good the shortfall in achievement of the revised target by placing a deposit with SIDBI for a period of one year.

Advances to the priority sectors by foreign banks in India in March, 1999 were 37.0 per cent of their net bank credit as against 34.3 per cent in March 1998. The share of export credit in March 1999 was 25 per cent of net bank credit while the small-scale industries accounted for 11.0 per cent of net bank credit. Thus priority sector advances of foreign banks exceeded the prescribed minimum of 32 per cent.

It is, however, essential that the Reserve Bank should have a more effective control over foreign banks. Restrictions may be placed on the aggregate volume of deposits which the foreign banks may raise and use. They should also be prohibited from undertaking trustee business in India. The granting of commercial privilege should be based on the principle of reciprocity. We may also consider the feasibility of establishing purely Indian Foreign Exchange Bank by the Indian banks jointly to transact the foreign exchange business. Actually, we have not only to impose restrictions on foreign banks, but we have also to make efforts to improve the position of Indian banks in respect of foreign exchange business.

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CHAPTER



ROLE OF DEVELOPMENT BANKING

Development banking in India has witnessed a sea-change having undergone radical transformations in its structure and organisation as well as in the scope and contents of its business operations.

In this chapter we will study the role of development banks in the process of change in which the exploitation of resources, the direction of investment, the orientation of technological development and institutional change accelerate economic growth. Economic growth, poverty alleviation and proper management of natural resources must be viewed as mutually interdependent facts of ultimate development goal.

Role Concept :

The term role is often used in different contexts especially that of acting. Role is the set of expectations behaviour of individual and/or business organisation. Expectations about role playing are closely associated with a group norms and culture of a group. In India, development banks have developed a different culture and thus they stand distinct from all other financial institutions. The

technique of role-playing can be adopted for various purposes and the nature of the technique would differ for different purposes. The main focus here is on role clarity, effectiveness and improved fit between the institution and the role. By sharing common role problems, development banks may develop alternating solutions which result in better performance.

Financial Sector :

Financial sector development is not an end in itself. It is to promote and sustain productive activities in various economic sectors by providing needed financial products and services. For the financial system to perform this function adequately and effectively, individual institutional efficiency alone would not suffice. There should also be a conducive policy environment, political stability, political will and entrepreneurship. In addition, financial institution should have adequate autonomy to bring in initiative and innovations to growth. More importantly the financial institutions should be flexible in establishing backward and forward linkages for all round growth of the economy.

Development Goals :

The important objective of the development bank, is to promote the development of industry, agriculture, trade as well as capital market. Development in this sense implies a steady improvement of living standards achieved through increases in income, improvement in social conditions, and protection of the natural environment. Economic growth is fundamental to development.

Economic growth, while important, has not been seen as an end in itself; in line with this perception the Asian Development Bank (ADB) has become increasingly aware that its efforts should contribute to overall development. Expansion of social infrastructure, poverty alleviation and conservation of the natural resources receive more attention, as the ADB seeks to help improve the living standards and quality of life generally. Faced by this showing diversity, the ADB has sought to respond appropriately by extending the scope of its activities beyond the confines of the traditional approach.

Need to Develop Capital Market :

The development banks have been in the forefront in strengthening the capital market with a view to give a much needed impetus to the growth of private sector activities.

All the development banks established in the country since independence are expected to encourage and promote healthy growth of the capital market with a view to mobilising private savings into industrial securities. The respective charter of IFCL, IDBI, ICICI, SFCs/SIDCs, LIC and UTI enjoin on them supporting issues of industrial securities through underwriting and/or direct subscription.

It was expected that the mere support of the financial institutions to the equity issues would act as an indicator that such industrial ventures were support worthy in view of the thorough investment appraisal by the institutions that is involved before the institutions extending underwriting support.

Over the last two decades, however, the experience of the institutions in regard to their underwriting operation has been somewhat different. The mere fact that an issue has been underwritten by the institutions no longer gives an assurance to the investor that the industrial security is worth purchasing. In reality what has happened is that whenever the major term lending institutions are involved an impression prevails in the market that the industrial security being issued is not necessarily attractive from the point of view of the private investors but that institutions have offered the underwriting support in the national interest, as an exercise for toning up the entire financing plan for the project.

The trends in sanctions and disbursements against underwriting direct subscriptions to equity and debentures in relation to the trends in equity and debenture capital raised from the market indicate that institutional support to the capital markets is growing over time. The institutions, therefore, are obliged to absorb growing proportion of the issues coming to the market with their underwriting assistance.

A number of measures are being suggested for activising market for industrial securities so that a larger flow of household sector's

savings is available to the corporate sector. The several areas in which some positive action is called for relate largely to suitable changes in direct and indirect taxes, and the policy of the term lending institutions relating to their investment in industrial securities. But I am confining here only to the measures that institutions adopt to active capital market.

In conformity with their chief objectives the term lending institutions need to give greater importance than in the past for encouraging growth of the capital market. As a first major step in this direction the institutions need to reconsider their policy of holding on to their sizeable investments in easily marketable industrial securities. Bulk of the investments of the institutions in shares and debentures are as a result of development of part of the issues underwritten by them in the past as also due to an exercise of their convertibility rights in respect of the loans to assisted concerns. With a view to creating a wider market for industrial securities and also for recycling the funds required for their growing volume of operations, institutions should, more than ever in the past, give greater attention to unloading of their holdings. As a matter of policy the preference of the institutions should be one of not holding on to the securities in which investors are interested.

The disinvestment operations by the institutions could be undertaken in an orderly fashion without creating unstable trading conditions in the stock markets. Institutions could offer for sale these securities in the same manner as some companies do whenever they are expected to broaden their shareholding through sale of part of the large block of shares held by one or a few shareholders with controlling interest. I am sure such a measure would not at all affect the sentiment of the market whenever such orderly disinvestment are undertaken by the institutions.

Dispersal of Financial Assistance :

Sometimes, it is pointed out that institutional assistance flows largely to States which are already industrially well developed. Apparently this may be true but one should not try to draw wrong conclusions from the trends in institutional assistance. It is true that industrially more developed states, particularly Maharashtra,

Gujarat and Tamil Nadu continue to receive major chunk of assistance extended by the institutions.

In this context the basic operational objective of the all-India financial institutions needs to be taken into account before drawing any conclusions about their inter-state distributional pattern of assistance. The institutions, no doubt, accord priority to the major socio-economic objective and to more even distribution of assistance particularly in favour of the relatively less developed regions, but they consider that overall viability of assisted projects based on economic, financial and technical considerations should be accorded due importance.

The flow of institutional assistance depends essentially on the level of entrepreneurial activity in different states. The locational decisions of industrial units are largely outside the preview of financial assistance. As far as the all-India institutions are concerned, they would prefer to go by the locational decisions of entrepreneurs and of the licensing authorities. The institutions offer incentives to influence location of projects as between backward areas and others but not between states. Different states and their SIDCs offer attractive participating terms in respect of their assisted/joint sector projects. Competition among states to attract industrial units by offering incentives quite often results in more or less equalisation of incentives, leaving the locational decision finally to the entrepreneurs than to the inter-state incentive patterns. Hence, the flow pattern of institutional assistance among different states is the outcome of the relative advantages, real or fancied, perceived by the entrepreneurs in locating their units in particular states.

Development of Backward Areas :

Industrial dispersal coupled with development of relatively less developed areas has been the integral policy of the national development plans as also the lending policies of the financial institutions. But a specific incentive framework designed exclusively for the development of identified backward areas was adopted by the institutions only since the beginning of 1970s.

There are a number of fiscal concessions for investment in backward areas which are important for attracting investment in

the earlier neglected areas. The financial institutions offer concessions in terms of lower interest rates, longer moratorium period, easier repayment schedule and more favourable treatment in regard to promoter's distribution and debt-equity norms. During the last decade, there has been a substantial spurt in assistance sanctioned to units in backward areas which increased from Rs. 143 crore during 1974-75 to Rs. 842 crore in 1979-80 and further to Rs. 21,888 crore in 1997-98. Of the total institutional assistance of Rs. 3,63,184 crore, the share of units in backward areas was at Rs. 1,18,786 crore and disbursements amounted to Rs. 82,069 crore.

With a view to making the national policy for development of backward areas more purposeful and effective, Planning Commission had set up a high powered Committee called the "National Committee on Development of Backward Areas", which submitted its report in October 1980. Recognising the inadequacies of existing incentive framework, the Committee was in favour of giving focal attention to the growth of certain identified centers around which further growth of certain identified centers needs to be accelerated. To begin with, the Committee recommended adoption of 100 suitable locations as growth centers (70 of which would be in industrially backward states), each under the charge of a developmental authority that would be created to provide a package of services, infrastructure and incentives conducive to healthy growth of industries within the defined boundaries of the growth center. The Committee has accorded a central role to IDBI in the development of these growth centers. It is envisaged that IDBI would actively help the growth centers in a number of ways, including their planning and financing.

Growing Industrial Sickness :

There is a fallacious assumption that finance would be the panacea for industrial sickness in the country. The nursing of sick units is necessary in the country, in the interests of sustaining production and employment, but is it the sole responsibility of the banks and the financial institutions? The attitude of most of the State Governments in this regard is apathetic. They are concerned more with sustaining employment than production and very often

the pressures of labour unions weigh more in their consideration than viability of the unit. There are also cases where the management of sick units throw them in the laps of banks and merrily start new and more profitable ventures. The promoters and management's of six units believe that banks will not be allowed by the Governments to close an industrial unit.

Rehabilitation of sick units calls for a concerted and co-ordinated approach on the part of all concerned, financial institutions, banks, State and Central Governments, other creditors and more particularly the promoters and labour who are directly concerned with the unit. There is a tendency to pass the burden of revival of the unit on the others, with the result that banks which have large stake in the unit have to bear the heaviest burden in the form of the relief's and provision of further finance. The ultimate objective of revising an otherwise viable unit is conveniently forgotten. Thanks to the inordinate delays that ensure, the unit is allowed to become more sick and even reach a stage of irretrievability. On the other hand, an irretrievable unit is compelled to stretch its parasitic,

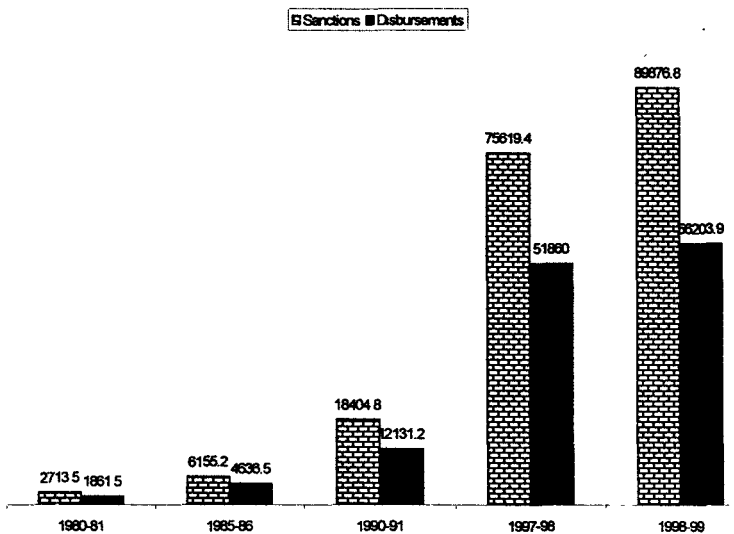


Fig. 1 : Assistance Sanctioned and Disbursed (Rs. Crore)

existence. Surely, in an environment where survival of business is impossible, there should be freedom to close shop. The decision to nurse a sick unit should be taken purely on professional considerations. While social considerations cannot be ignored, they cannot be the sole guiding factor and in any case the entire burden of social cost' should not be passed on to the banking industry.

Since the inception of development banking activity, all financial institutions as (development banks) have sanctioned Rs. 5,20,653 crores and disbursed Rs. 3,62,711 crores. Assistance sanctioned is expected to catalyze an investment of the order of Rs. 32,02,455 crores. This is the lowest expected investment.

According to an ICICI study, on an average, an investment of Rs. 3.48 lakh in gross fixed assets is required to create one job in 1991-92 as against Rs. 2.95 lakh per job in 1990-91. Even taking into consideration the latest figure, the investment by development banks would generate employment opportunities around 91.50 million. On the other hand, SIDBI has envisaged that their operation is expected to catalyze an aggregate investment of Rs. 24,175 crores and create additional employment of 60.5 lakhs in the small-scale sector on completion of the assisted projects. Here, the per person investment is as low as Rs. 39,959. If this is materialized, the development banks' contribution to human development will be quite unique. They will be setting to enforce a chain of positive activities, which will boost the economy. More importantly, they will improve the living standards of the people.

This apart, in the process, the financial institutions have helped create additional capacities in a large number of industries. Again, there will also be a spurt of new industries, new services, innovative products and large turnover, higher sales, higher profits. In this sense, the role of development banks is not only catalytic but also unique and significant.

The relatively high growth rates achieved by the mining, manufacturing and construction sector since the inception of planning in India resulted in sharp rise in its share in the national output from 14.9% in 1950-51 to 38.9% in 1991-92. The development banks have played a significant role in bringing about the structural

transformation within the manufacturing sector itself. Although an appreciable part of their assistance continues to be in favour of some of the traditional industries of the country, *viz.*, textiles, food processing, *etc.*, the bulk of the assistance has been for the purpose of modernisation and technical upgradation of these industries so that their competitive position may be strengthened. A substantially large proportion of institutional assistance, however, has gone into the creation of new capacities in modern industries, such as chemicals, fertilizers, machine-making, commercial vehicles, rubber goods, paper and paper products, metals and metal products *etc.* As a result, the traditional food processing and textile industries, which accounted for 16% and 47% respectively of industrial output in the mid-fifties, lost their relative importance.

Component-wise Financial Assistance :

Of the aggregate assistance sanctioned by APIs, rupee loans formed 65.7 per cent, followed by foreign currency loans 10.5 per cent. Assistance sanctioned by way of underwriting direct subscription and guarantees accounted for 18.0 per cent and 5.8 per cent respectively.

While AIDBs sanctioned 83 per cent of rupee loans, investment institutions contributed 12.6 per cent. ICICI, IFCI and IDBI provided the bulk of foreign currency assistance. Over 80 per cent of the assistance under underwriting/direct subscription to shares and debentures came from the investment institution, the share of UTI alone being 48 per cent.

State-wise Financial Assistance :

In the aggregate assistance of Rs. 4,32,028 crores, the share of Maharashtra stood at 21.4 per cent followed by Gujarat 16.4 per cent, Tamil Nadu 9.0 per cent, Madhya Pradesh 8.5 per cent and Andhra Pradesh 7.2 per cent. These five states together accounted for 62.7 per cent of the total sanctions made by the development financial institutions.

Sector-wise Financial Assistance :

Private enterprise plays an important role in economic development. In providing employment in large numbers, the

private sector has made a major contribution to improving the living standards of the people in the last four decades.

In response to the growing emphasis on private enterprise, the development banks offer assistance to the private sector to promote efficient use of resources and to help accelerate economic development. Specially, the bank's role is to help private enterprises undertake financially viable projects which also have significant economic merit and catalyze the flow of domestic and external resources to such projects.

In keeping with the importance of private sector, all financial institutions have sanctioned Rs. 3,85,375 crore accounting for 80.8 per cent of the total, followed by public sector 14.0 per cent, joint sector 4.1 per cent and the co-operative sector 1.1 per cent.

Eligibility for Banks Assistance :

The bank's assistance may be considered for projects to establish, expand, diversify and modernize productive facilities in various sectors, including energy, manufacturing, transportation, forestry, fisheries, meaning, tourism, health and agriculture. The project should produce or provide essential goods or services and serve national development objectives. Projects to produce non-essential or luxury consumer goods may be eligible provided the products are primarily for export. The Banks prefer projects, which use domestic raw materials, create jobs, employ modern management techniques and technology and those, which are export-oriented or lead to efficient import substitution, induce foreign investment and provide wider dispersal of ownership.

Cumulatively up to end March 1999, the infrastructure claimed the highest share of 16.6 per cent (Rs. 79,086 crores) in assistance sanctioned by AF's, followed by chemicals and chemical products 11.5 per cent (Rs. 54,686 crores), services 11.0 per cent (Rs. 54,254 crores), basic metals 9.3 per cent (Rs. 44,505 crores), textiles 9.5 per cent (Rs. 45.521 crore) and electricals and electronic equipment 3.4 per cent (Rs. 18,413 crore). These together accounted for 61.0 per cent of total assistance.

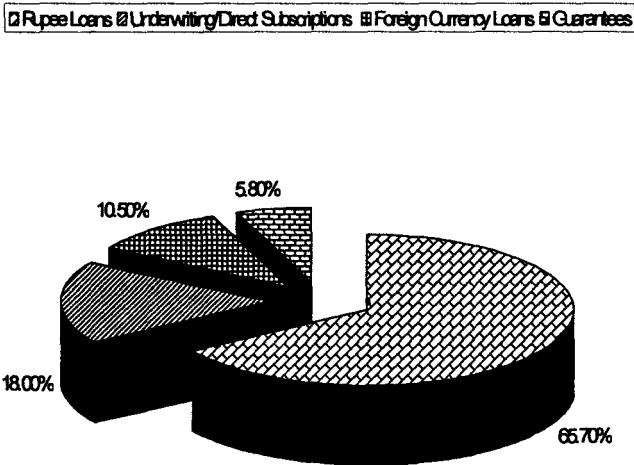


Fig. 2 : Component-wise Break-up of Cumulative Sanctions

Financial Assistance to Small Scale Industries :

Small scale industries are provided finance and extension on service support by development banks such as SFCs, NSICs, SSIDCs, KVIC, NABARD and SIDBI. While other agencies are serving the small scale enterprises at the grass root level, NABARD has its focus on rural areas through linkages with the banking system. SIDBI has been set up as a principal financial institution for promotion and financing of the small scale sector.

The SIDBI has sanctioned Rs. 36,263 crore and disbursed Rs. 26,701 crore under their various schemes of assistance. In addition, SFCs have sanctioned Rs. 18,216 crore and disbursed Rs. 15,536 crore to 5,78,457 small-scale industries up to end March 1998. The average per unit sanctions and disbursements amounted to Rs. 2.86 lakhs and Rs. 2.15 lakhs respectively. Efforts are under way to step up the flow of assistance to small scale industries.

New Growth Paths :

In recent years, the very character and complexion of development banks are undergoing change. One such is the change

in the composition of business and assets of development banks with greater emphasis on non-project assistance. Non-project finance in the form of equipment finance, leasing, asset credit and bridge loans against public or rights issue of shares and debentures is now on the increase. Of late, development banks have become more selective and cautious in respect of project finance. In fact, non-project finance is less risky, there is assured repayment, for shorter duration with higher rates of return and thus more profitable.

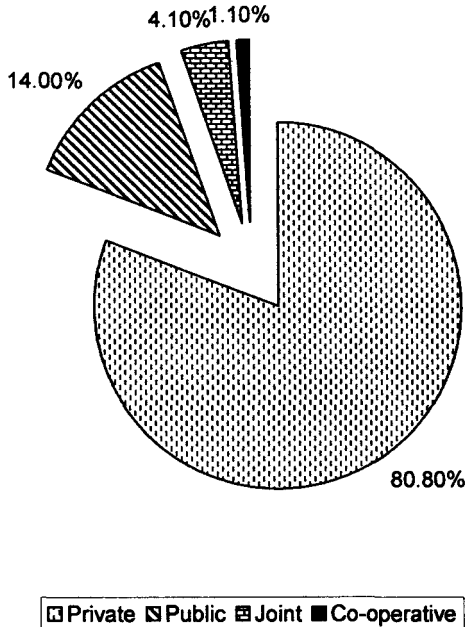


Fig. 3 : Sector-wise Cumulative Sanctions

Another development related to raising resources at reasonable cost is the strategic decisions taken by IDBI, ICICI and have resorted to the public issue of unsecured bonds, certificates of deposits and public deposits. The equity base of development banks is being broadened.

In the nineties, development banks are competing with each other for good business. Further, they have become increasingly conscious of the need for improving the quality of their portfolio. They are adopting prudential exposure norms and are classifying their assets into four groups—standard, sub-standard, doubtful and loss—a classification internationally followed for determining loan provisioning.

Development banks seeking new growth paths should not be deviated from their responsibility of promoting projects and encouraging new generation entrepreneurs. More importantly, worthwhile projects should be allowed to flounder for want of finance.

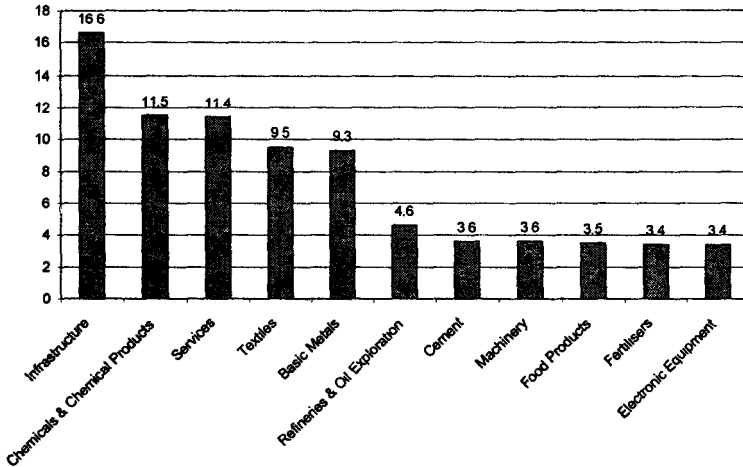
Catalytic Agent :

In four and half decades, the new species of development banking has emerged as a powerful instrument of economic development in several developing countries including India. The concept of development banking and the areas of activities that are rightly said to be belonging to development banks have proved to be ever growing. While increasingly new demands are being made on them, both in regard to volume of finance and on their multifarious developmental and promotional services, it is not being adequately appreciated that there is always an inevitable and unavoidable time lag between the point of time when new demands are made and the minimum time required by the development banks to equip themselves organizationally to cater to new demands. Some of the problems arising out of industrial sickness and entrepreneurial behaviour or the developmental, and promotional tasks of building up entrepreneurial cadre among sections of society, not usually supply effective entrepreneurial talent, or orderly development of relatively backward areas *etc.* are all relatively new and challenging areas. Since all these are complex and onerous tasks not always assuring quick results, the rate of progress of development banks as seen by outsiders, may perhaps appear to be slower than what they would like. It, however, needs to be appreciated that development banking is not a technology but an art which tells us as to what our goals are but does not provide us unambiguous and ready-made

solutions. Hence, our search for satisfactory solutions has to continue.

Development banks today have come of age. They are, and have been acknowledged to be the prime movers of change. They have been and remain, in the vanguard of professionalised management as well as of better systems of management. They are promoters and vehicles of more rapid and broad-based economic growth through wide ranging stimulus to entrepreneurship development in their respective economies. Development banking has, indeed, travelled a long way. One of its durable concerns, indeed, is to assist in setting on foot viable productive projects with supplementation of capital. Time was when the assistance given by a development bank was related primarily to the security that a borrower could offer. In this respect, the shift to the wide considerations of profitability and productivity of a venture and its contribution to the economic strategies of the country, as well as furtherance of the objectives of its social policy, is now an accomplished fact.

Over the years, the DFIs have come to occupy a place of importance in the planning and promotion of industries in the country. Responding to the emerging requirements of industrial and economic growth, they have not only constantly increased the flow of assistance, but developed a co-ordinated approach to industrial financing. Within a span of 45 years or so, a wide network of DFIs has been established; and some of these have specialized in particular areas of development finance. At the same time, all DFIs have introduced important organisational changes, including decentralization and delegation of powers to their *branch* offices. Lending procedures have undergone changes in response to emerging requirements. As a result, the process of appraisal of project finance proposals as well as of sanctioning and disbursement of assistance has become considerably simpler and quicker. Simultaneously, consistent with their role as catalysts in economic development, the financial institutions have been continuously enlarging the scope of their operations — from providing financial assistance to identification of industrial opportunities, identification and training of entrepreneurs, provision of techno-economic



Consultancy facilities, industrial research and other promotional activities.

Thus, institutions are playing a significant role in creating fresh capacity in a large number of new projects as also the expansion/diversification of existing units. There is hardly any project in the private sector especially the larger ones, which could materialize without substantial support from the institutions. Even as regards the small and medium scale projects financed by the State-level institutions their financial support varies from 50% to 75% of the total project cost.

With an increasingly important role played by the financial institutions in industrial investment, during the last decade, institutions are becoming aware of some of the inadequacies that exist in their lending strategies, support to capital market, development of backward areas and effective follow-up of assisted projects.

Future Role of DFIs :

The DFIs have been facing stiff competition ever since the entry of commercial banks into the medium and long term loan sector. Now the boundaries between the commercial banks and the

development financial institutions have blurred considerably. As a result, the DFIs have concentrated on more profitable areas so as to increase their income. Their focus seems to have shifted from the very purpose for which they had been set up. While all of them had been set up for the same purpose, IDBI is now concentrating on wholesale term lending whereas ICICI is all set to enter the retail segment with its strategic tie-ups. IFCI, despite being the oldest DFI in the country, has not been able to report positive net cash flows. The profitability of these FIs has also been eroded because of the lack of control on the growing non-performing assets (NPAs). In the wake of all this, these institutions might face an increasing problem in servicing their debt in the future. If it continues growing at such a rate, it might not be in a position to sustain the growth rate and might have to keep borrowing heavily from the market to service their debt in the future.

With the growth of universal banking, the future role of the Development Financial Institutions (DFIs) also needs to be re-examined. Many of them are entering into commercial banking business. The logical culmination of this should be that they be converted into banks and subject in a phased manner to the same regulatory and prudential norms as are applied to the banking system. We should thus have only two classes of financial institutions, namely banks and non-banks, and it is for the DFIs to decide whether they wish to continue to be non-banking or become banking institutions. Even if they were in the process of becoming universal banks, to take up normal commercial banking functions, the specialist expertise which they have acquired over the year in investment funding and term capital finance should not be lost.

In future, the participation and involvement of DFIs in the process of economic development will be still deeper as they intensify their efforts at the development of entrepreneurs, backward areas, small industries and export-oriented units as well as at the upgradation of technology in the traditional sectors. The tasks ahead are varied and challenging. Fresh demands may not only call for a substantial step up in resource mobilisation efforts to keep pace with growth in the volume of financial assistance but may also require an

orientation of the policies and priorities for allocation of assistance. Equally important will be the demands of multifarious promotional and developmental activities. Considering the strength and flexibility of the development finance system that has been built up over the years, the DFIs in India should be able to respond competently and adequately to future demands and add newer dimensions to the field of development banking.

Critical Appraisal :

A plethora of financial corporations catering to the financial needs of different industries, had come into existence, each one functioning within the narrow framework set down by the statute or the memorandum that accredited it. The multiplicity of financial institutions operating in the same field with hardly any demarcation in their specific activities led to overlapping and duplication of their efforts with the result that financially well-off concerns could manage to procure financial assistance from a number of institutions, while the weaker concerns were left high and dry. A coordination of functions and working of financial institutions was, therefore, considered necessary so that they might play a more useful role in the industrial development of the country.

Many gigantic projects of national importance were held up because of the absence of financial arrangements. Furthermore, a large number of industrial projects were envisaged to be set up during the fourth and succeeding plans to achieve self-sufficiency in the industrial sector; and this called for a substantially large amount of capital provision, which the existing institutions were not able to supply in view of their own limited resources. The establishment of a financial institution with a substantially larger amount of resources and capable of functioning undeterred by statutory rigidities, therefore, became inevitable.

The DFIs were set up to provide the necessary capital and know-how to business enterprises so as to bolster the industrial growth of the country. Till 1991, they had been functioning in a highly regulated environment and had enjoyed a comfortable spread since the cost of their borrowings had been considerably lower than the return on their financing. Since deregulation, and after the easing out of cheap SLR funds from the government, there has been an

increasing funds in the market. In the past few years, they have borrowed large amount of funds by floating a number of innovative debt and equity issues catering to the needs of various kinds of investors.

Over the years, the development banks have failed in these crucial areas:

1. DFIs have financed industrial groups rather than new entrepreneurs.
2. Entrepreneurship development lacked commitment and innovation.
3. Inordinate delay in sanction and disbursement.
4. Emphasis on plurality of institutions assisting the same project.
5. Dilution of the standards of scrutiny of project proposals.
6. Absence of project monitoring and implementation.
7. Inability to build up adequate expert staff, both technical and financial.
8. Their incapacity to advise the new entrepreneurs on various matters from project idea, formulation, execution and implementation.
9. Distortion in the growth of a developed capital market.
10. The development financial institutions in India lack in vision, innovation and enterprise. In the process, they have inherited the bureaucratic attitude.

Judged in these terms, although the quantity of funds flowed through these channels is huge, but it failed to generate sources of saving to retain the qualitative tempo of industrial development on a sustainable basis. It is right time to reorganize the development institutions to accelerate the process of equitable and healthy industrial development in the future.

Conclusion :

With the adoption of planning for economic development, the building up of an appropriate structure of development finance

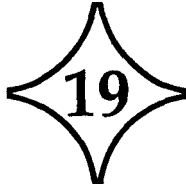
institutions has been of crucial importance. The first decade of Indian planning witnessed the emergence of a number of development banks, both at the all-India and regional levels.

Over time, as the industrial structure of the country became more diversified, the activities of development finance institutions not only widened, keeping pace with the growing needs of industry, but became increasingly complex and wide-ranging. In recent years, while efforts at filling the gaps in the institutional structure for the promotion and financing of industry have been intensified, a need has arisen from a more effective co-ordination of activities of the different institutions and for evolving integrated financing institutions for the industrial sector. In addition, new development institutions have been established to cater the needs of agriculture, and foreign trade in the eighties. New guarantee institutions too, were moulded to cater to the needs of the weaker sections of society.

At present, the country is served by over 370 development banks with a wide network of branches, and supported by technical Consultancy organizations. The Industrial Development Bank of India is acting as the apex institution for co-ordinating their diverse financing and promotional activities. The strategies, policies and industrial promotional efforts of these institutions sub-serve the larger national objective of rapid industrial growth, balanced regional development, self-reliance, employment generation and equitable distribution of income and means of production.



CHAPTER



DEVELOPMENT BANKING IN INDIA AN ASSESSMENT

The structure of development banking has been broad based and deepened in stimulating Indian economy. A critical assessment of development banking of our country has been made in this chapter.

Fostering Role :

India has a well-knit structure of term-financing institutions, popularly known as development banks, at the national and state levels, meeting the vital long-term, financial and developmental needs of industry and agriculture in the country. And the recently set up Housing Bank will cater to the needs of housing development in the country. The development banks along with other financial institutions are playing a catalytic role in the accelerated development of the Indian economy.

The development banks have played an important role in the economic development of India. They have emerged as the backbone of the Indian financial system.

Along with their rapidly growing size of the capital market, the institutional operations in regard to underwriting and direct subscriptions have also been expanding.

The statutes of IDBI and IFCI have been amended so as to broaden the areas of their activities. In view of the growing importance of service industry and in particular informatics, the institutions have been enabled by the amendments to assist such services as Consultancy in engineering, technical, financial, management and marketing areas, enterprises providing medical and health services and units providing service relating to information technology, telecommunication or electronics as also research and development activity. Suitable amendments have also been made in the Statutes of the State Financial Corporations to enlarge the scope of their activities. IDBI has already introduced the Venture Capital Fund Scheme for commercializing indigenous R & D and commercial adaptation of imported technology to domestic uses.

Quantitative :

Quantitatively, the development banking institutions have outgrown their supplementary character of gap fillers. Today, the development banking institutions provide a varied types of financial assistance, guidance and support to industrial enterprise.

The remarkable growth of financial help to Indian industry is assessed by the trend in the volume of assistance sanctioned. The average sanctions were Rs. 2.71 crore during the formative stage (1948-51), rose to Rs. 7.49 crore in the First plan. It rose sharply to Rs. 2,713.60 crore in 1980-91. During the last five years, the development banking institutions extended assistance of Rs. 3,27,047 crore, accounting for 64.8 percent of the total assistance till end march, 1999. It touched an all-time record of Rs. 89,876.80 crore in 1998-99.

Cumulatively, rupee loans aggregated to Rs. 1,78,615 crore (35.4%), followed by direct subscription Rs. 61,422 crore (12.2%), foreign currency loan Rs. 53,057 crore (10.5%), refinance Rs. 43,712 crore (8.5%). What is more 81 percent of the total sanctions has been claimed by private sector.

The figures cited above are amply indicative of the important role of the development banks in industrial financing in India. They,

however, do not disclose the real impact of their financial operations in quantitative terms. In other words, in an assessment of their quantitative role certain important dimension merit consideration. In the first place, while assessing their role one has to consider the facts of economic life in India, particularly, during the last decade. In spite of the fact that the conditions in the investment market have been, as is well-known, by and large unfavourable, the development banks have been able to push up investment in the private sector.

Stimulating Role :

The relevance of development banks in India has an promotional functions. It should be construed as an important factor in the sustained industrial development.

The small scale industry sector which has been receiving sizeable assistance from institutions has been given special focus by setting up a Small Industries Development Bank of India. The SIDBI will provide the focal point for accelerating the flow of financial services commensurate with the growing requirements of the small-scale sector. In addition to operating the on-going schemes, new schemes are being devised to cater to the needs of the small sector with special attention to the needs of tiny and rural industries.

Promotion of Entrepreneurship :

The bank's experience in promoting entrepreneurship has been that if all the multidimensional aspects of this process are to be handled only by them, the progress would be tardy, with the added disadvantage of the duplication of organisational and technical machinery in banks and consequential higher costs. Accordingly, banks have endeavoured, wherever possible, to operate a research clinic in collaboration with State development agencies and various organizations representing industry, commerce and trade. Various schemes have been formulated by banks to help entrepreneurs to exploit their opportunities in the ancillary industrial sector. The clinic has already compiled an exhaustive dossier from which a prospective entrepreneur can get information about the various components of the schemes. Once he has chosen his line of

manufacture, he is put in touch with a large industrial unit to help and guide him in following way :

- (i) The preparation of project report;
- (ii) Arrangements for “in-plant training”, if necessary;
- (iii) The commissioning of the project;
- (iv) In solving the technical problems which may crop up in the process of manufacture; and
- (v) Helping him to standardize the quality of his product and ensuring a minimum purchase order for him for a specific period of time.

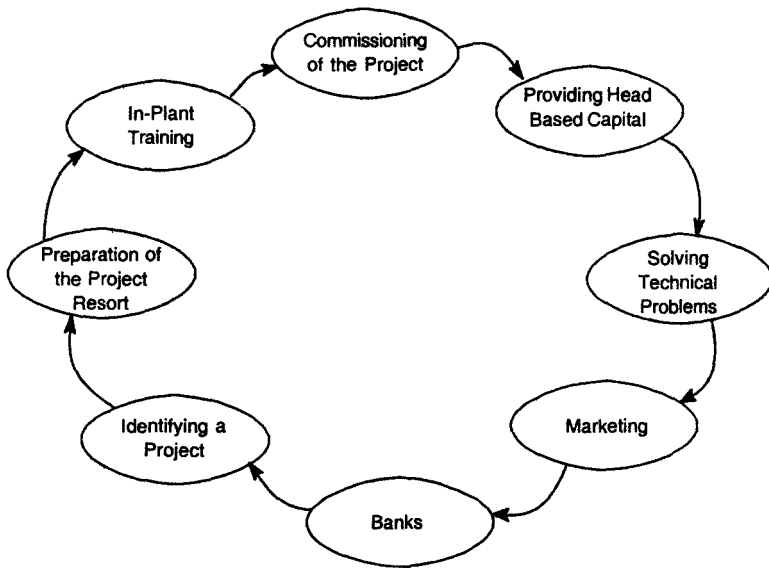


Fig. 1 The Role of Banks as Problems of Entrepreneurship.

The clinic also helps the entrepreneur in securing registration, in the selection of plant and machinery, in locating the sources of the supply of raw materials, and offer him advice and guidance in technical matters. Moreover, it arranges full financial assistance for him from the banks on attractive terms. A distinguishing feature of these schemes is the linking of the prospective entrepreneur with

an operating industrialist who will act as his technical "foster-father".

At the same time, banks have made vigorous and sustained efforts to discharge their social responsibilities in other sectors as well. The banking philosophy now is to provide credit, and offer technical and financial guidance suitable for the specific requirements of each case. Banks also believe in the philosophy of creative banking with emphasis on dynamic lending, *i.e.*, lending which will make it possible for production to expand and result in increase in income and employment.

Banks have simultaneously been aggressive in promoting exports through a package of wide-ranging services. The small industrial sector has purposefully responded to the bank's efforts and has made a contribution, though small, to export promotion.

Catalyst in Social Change :

The development banks, as financial institutions, are only a catalyst in social change. With training programmes, they try to impress upon their staff that banks are for the people and that in a country in which the people are poor, the major objective of the bank is to associate itself with all the programmes for the amelioration of the conditions of life of the weaker sections. Training has been redesigned to meet the ever-growing and changing growth needs of bank personnel and to prepare them to meet the emerging challenges of the future. New methods of assessing training needs, new processes of involving the critical functionaries in the training areas, system to evaluate the effectiveness of training and systems to take training to the branches - these are some of the new developments in the banks training system.

The viability and excellence of an organisation depend upon the competence of its people. Having regard to this, the banks have introduced a Human Resources Development system. The HRD is a continuous process, which enables every individual, as a member of a team, to realise and activate his potential so as to effectively contribute to the achievement of the organisational goals. Banks also believe in building a culture of collaboration and team work at all levels. To achieve these objectives, appropriate systems have

been designed by the banks. A comprehensive and scientific manpower plan has been evolved, with the help of which it is now possible to assess not only the present manpower needs but also forecast future requirements. To enable our managers to perform optimally, a new performance appraisal system, has been designed and introduced. This system, in addition to bringing about clarity in respect of roles, provides timely feedback and promotes a healthier superior-subordinate relationship in the bank. A career plan model, which helps in systematically building up skills and capabilities through a proper placement policy, has also been evolved.

The Indian financial scene, particularly that of development banking, has thus undergone a profound transformation during the last one and a half decades. Banks are now expected to play a leading role in bringing about economic and social change. With a wide expansion of branches, banking is now closer to the masses; and the policies of the banks are increasingly oriented towards helping the weakest of the weaker sections of society. The evolution of the banks' policies in the field of rural credit, financing of small scale industries and other weaker sections, the initiative taken under the lead bank scheme in accepting the challenge of banking development in the most difficult areas of the country, in preparing comprehensive development-oriented district credit plans for sustained development, and the numerous other innovative banking schemes introduced by their offices are noteworthy features of the operations of the banks.

Future Role :

Development banking is a very sensitive industry which is constantly under the public gaze. Better customer service, whether in the urban or rural area, whether to the depositor or to the borrower, and the productivity of banks are the most vital factors to which this industry has to pay closer attention if it is to discharge its responsibilities in a satisfactory manner. However, the tasks before the banks are still unfinished and gigantic. With the greater emphasis on agriculture, the development of backward areas, on integrated rural development and the development of small and tiny industries in the Seventh Five-Year Plan, the banking system is expected to play a crucial role by the deployment of its funds in

rural areas, particularly in assisting agriculture, rural industries, and the small-scale sector on a preferential basis.

Moreover, in view of the Government's aim of full employment to all able bodied persons, the banks will be required to improve the flow of credit under self-employment schemes. The Working Groups set up by the Government have made several recommendations to improve the flow of bank credit to the weaker sections under the programmes envisaged under the Seventh Plan; and commercial banks will no doubt put forth their very best efforts to achieve these socially desirable goals. They have all along been in the vanguard of all the programmes which help the common man and have actively associated themselves with the financing of schemes under the Antyodaya programme. Block level plans have been drawn up under the Integrated Rural Development Programme with a view to assisting in the fulfilment of the objective of providing full employment to the rural poor. The widening network of the banks' branches has taken them nearer and nearer to the masses, and given them increasing opportunities of ameliorating their living conditions. Simultaneously, banks play a catalytic role in increasing industrial production and exports and accelerate the process of economic development, without compromising on productivity and profitability.

Gearing for Change :

The winds of change in the financial sector reforms have forced the leading financial institutions to redefine their objectives and extend their area of operation. Therefore, they have begun the process of entering commercial financial services such as banking, merchant banking and asset management of mutual funds. Steps have also been taken to restructure their equity bases to resemble other financial institutions. And the public is being invited to participate in the share capital, it is timely to reorient their activities to the new economic environment. This is first the beginning of the process. From a static and comfortable financial system, the major financial institutions have now been propelled into a dynamic and competitive system. Some of them have been fuelling ambitions and dreams. Breathing life into promising business ventures. Partnering companies on the move, till they reach the peaks of success. And,

help industries to race past and stay ahead of competition, by taking inspiring business ideas.

While, the comforts of cheap credit and fixed rates of return are not available any more, they have now opportunities to enter areas of high growth financing and compete with commercial banks and finance companies. In fact, five years down the line, there may not be any distinction between commercial and development banks. At the same time, the inclination to earn higher yields might push the institutions to take higher risks. The task is then that of the supervisor to see that prudential financing norms are not lost sight of in their rush of profits. At the same time, the era of consolidation of financial sector is imminent. Similarly, continue to be a visionary leader and a catalytic agent of change and development. There are many fundamental issues that will have to be faced sooner rather than later. The most important issue will be the nature in control of government over these institutions. As long as government retains the majority of shares, what will be the role of government in control, management and direction of these institutions. And is it the most efficient use of government's scarce capital resources to lock up large investments in institutions that perform essentially commercial functions that other private finance companies can also do. What role in a market economy is there for such institutions?

Conclusion :

In recent years, banks in India have been functioning more as leaders in development and instruments of national policy than as *dealers in money*. The concept of banking as mere depositories of the community's savings and lenders to credit-worthy parties having substantial worth has given way to the concept of purposeful banking sub-serving the growing and diversified financial needs of planned economic development. The emphasis has now shifted to lending according to national priorities and helping the hitherto neglected and weaker sections of the community in their productive activities.

While breaking new ground in the socio-economic field, where the cost factor is relatively higher, banks have ignored their over all business, domestic as well as overseas.

Domestically development banks have made good progress in mobilising higher deposits and simultaneously, their lending portfolio (increased) for they **now** cater to the needs of millions of new entrepreneurs and assist them in their ancillary business activity, with the result that they have managed to improve steadily their operating results.

All in all, the development banks are today in a much stronger position in terms of financial and organisational strength to enable them to meet the emerging challenges that lie ahead than they were in the past. Already the 1980s have witnessed a phenomenal growth of the banking industry both in size and in the variety of its operations. The bank's involvement in the rural areas has also undergone multidimensional changes. The development banks' penetration in project financing, schematic financing will accelerate the process of economic growth in the new millennium.

A planned approach to operations would help increase their efficiency and in turn, prepare them to undertake increasingly **challenging developmental tasks** with a view to accelerating the **growth of the economy**, eradicating poverty, creating employment **opportunities**, raising the living standards of the masses, and preparing the country for the challenges of the 21st century. The development financial institutions should strive to live up to the expectations in strengthening the economy of the country. Indeed, the task is Herculean, but not impossible.

Reforms Measures :

In the banking sector, significant measures on the deposit and advances front, including shortening of the minimum maturity period for term deposits from 15 days to 7 days with regard to wholesale deposits of Rs. 15 Lakhs and above, relaxation of Prime Lending Rate (PLR) as the floor rate for banks and rationalization of interest rates on export credit, are expected to foster greater competition among banks. The move to increase the interest rate on cash balances maintained under the Cash Reserve Ratio is significant step towards reducing the regulatory burden, which would have a direct beneficial effect on the banking sector's profitability. During the period under review, the RBI issued revised

guidelines for valuation of investments for banks and financial institutions. The prudential norms for recognition of loan impairment in respect of banks and financial institutions have also been made more stringent.

On the regulatory front, banks and financial institutions are expected to benefit significantly from measures announced in fiscal 2001 for the eventual repeal of the Sick Industrial Companies Act (SICA), and enactment of legislation to facilitate foreclosure in the case of loan defaults, which would aid efforts in loan recoveries and in reducing the burden of non-performing loans. Further, in the recent monetary and credit policy in April 2001, various measures have been proposed to rationalize the operations of urban co-operative banks, in order to provide greater security for depositors and members of such banks. In the current context, the proposed abolition of Banking Service Recruitment Boards, giving autonomy to nationalized banks in recruitment procedures, is a positive step for improving their competitiveness. All these measures are aimed at enhancing the overall financial strength and stability of the financial sector.

Technology continued to provide an impetus to growth in the banking sector, with almost all leading private sector banks having adopted the internet in an attempt to gain a competitive edge. As banks attempt to personalize their interaction with customers, improve their understanding of customers and develop a customer-centric orientation, they are likely to face increasing technological challenges in order to remain competitive. In this context, the ability of banks' IT architecture to cope with these challenges is of supreme importance in the eventual determination of their success.



CHAPTER



IMPORTANCE OF MONEY

Modern economy, though differing widely in many respects, are all monetary economies. In the world of today money reigns supreme. There is no phase of life which the monetary system has not affected. Whether it is the horizon of economics, sociology or politics, ethics or art, whether it is peace or war, money is the guiding star. An effectively operating monetary mechanism is a necessary condition for the smooth working of an economy. Money is an active factor which plays an important role in the economic system. Traditional economists, however, visualized money as a mere convenience. Economists of the nineteenth and early twentieth centuries looked upon money as a "Veil" which had no independent effect on economic activity. The history of money actually speaking is in large measure a history of public opinion about money. There has been no uniformity of opinion regarding the actual influence of money and monetary policy on the working of an economy.

Traditional View Point :

Classical economists did not give much importance to money as an independent variable capable of disturbing the functioning of the entire economy. For them money was simply a device or a mere convenience merely as the means of acquiring the goods and

services which are the real objects of their desire. In their view, the total amount of employment, the volume of production, the types and proportions of the various goods and services produced and consumed, the exchange values of the various goods and services in the market and the distribution of real wealth and income among the members of the community are normally the same in a money economy as they would be in a highly developed and efficient barter economy. Adam Smith had compared money to a "highway which while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either." In the words of John Stuart Mill :

"It must be evident, however, that the mere introduction of particular mode of exchanging things for one another by first, exchanging a thing for money and then exchanging the money for something else, makes no difference in the essential character of transactions.

"There cannot, in short, be intrinsically a more insignificant thing in the economy of society than money : except in the character of a contrivance of sparing time and labour. It is a machine for doing quickly and commodiously what would be done, though less quickly and commodiously, without it; and like many other types of machinery it only exerts a distinct and independent influence of its own when it gets out of order".

Why did classical economists consider money as an important factor in the functioning of an economy? The answer is that they assumed the stability of the value of money. Their main interest lied in the long run. Guided by Say's Law of Markets they believed that the supply of money would adjust itself to the demand for money in the long-run. Although Mill had conceded that money "exerts a distinct and independent influence of its own when it gets out of order", yet it was believed that possibilities of occurring such a disorder were rare. They assumed the existence of 'equilibrium conditions' where all factors of production, output, costs and prices become so adjusted that there would be no incentive for further changes. It was also assumed that in the long run there was no 'money illusion' and that both money wage rates and prices were

perfectly flexible. In the long run, money wage would adjust flexibly to demand and supply conditions in labour markets and prices would adjust flexibly to changes in costs. With the general price level assumed to be constant, the decision-makers responded to relative prices—the prices of what they sold relative to the prices of things they bought. This is precisely what the traditional individual firm analysis does. Accordingly the classical economists relegated a theory of money to the background of the value theory.

Veil of Money :

Many economists of the nineteenth and early twentieth centuries had a common tendency to regard monetary phenomena as rather misleading reflections of real phenomena on the ground that money obscured the otherwise transparent exchange relations. They, therefore, placed more emphasis on the production, exchange, and consumption of goods. The level of production depends primarily on the existence of a favourable combination of 'real' factors—a skilled and energetic work force, abundant and readily accessible natural resources, and a large stock of up-to-date capital equipment. But money, being the medium of exchange, conceals the actions of real economic forces, sometimes so effectively that we forget that there are any real economic forces working at all. Keeping this in view, the economists spoke of "the veil of money" indicating their feeling that whatever its convenience, money did not alter the fundamental processes of production and distribution, which could conceivably be carried on without it.

Pigou has mentioned a number of metaphors, which were in common use among economists in the years preceding the First World War. 'Money is a wrapper in which goods come to you' 'money is the garment draped round the body of economic life' 'money is a veil behind which the action of real economic forces is concealed.' Pigou himself speaks of it as a veil, because money, in his view, does not comprise any of the essentials of economic life. He writes, "Take the real facts and happenings away, and the monetary facts and happenings necessarily vanish with them; but take money away and, whatever else might follow, economic life would not become meaningless". Material well being is improved

by producing more goods, never by simply increasing the money supply.

The supporters of 'veil attitude' regard money as just a medium of exchange, a tool of convenience, which facilitates the process of economic activity, but not as a determinant of the level of that activity. They argue that money is a veil which the economists must pierce through to have a look at what is real, *i.e.*, the production and consumption of goods and services. Monetary phenomena do not vitiate the fundamental laws that govern economic behaviour, for it remains true that the physical law of diminishing returns and the psychological law of diminishing utility had existed even before the advent of money and will probably exist even after money is abolished.

If money does not create anything, then what does it actually do? To those who consider money as a veil, it is an important device for exchange. It helps to carry goods and services to their destinations, that is the consumers, but it is not a determinant of the quantities produced for them. Functioning as a medium of exchange, money makes it economically advantageous to carry on a great deal of interchange among various sorts of goods and services. Such an interchange contributes to economic welfare by promoting a desire to produce more. It is not really money that we want; it is what we can buy with the money. Thus money is like a railway ticket which is desired not for its own sake. It is desired because it enables the possessor to undertake journey and reach his destination.

According to 'Pigou, money as an economic instrument "constitutes at the least a very use full lubricant, enabling economic machine to function continuously and smoothly".

Pigou is prepared to accept that money is only oil in the machinery. But is it not a fact that if the oil is removed, the machinery may grind to a halt? The veil attitude towards money is based on some convenient and comfortable postulates which evade the real issue. Money does not function as a medium of exchange alone, it also helps actively in the process of production and distribution through its other functions. Money performs some dynamic functions also, which bring about a change in the nature and the

working of an economy. Money is not a passive veil or a meaningless symbol. It is a real, which is liable to influence the economy substantially particularly when it gets out of order. The practical experience suggests that monetary mechanisms tend to be 'out of order' more frequently than was envisaged by earlier economists.

Money Illusion :

The money illusion arises when an individual associates money directly with its face value without considering its purchasing power. It is the psychological valuation of currency or the emotional intensity displayed towards money without regard to its purchasing power. This emotional attitude results from transferring to money the intensity of desire for the things it will buy. The tendency to mistake money for wealth is another aspect of the money illusion. To a greater extent, money incomes and wealth are, for many people, indicators of prestige, social status, and achievement in the eyes of others and one's self. Because money is the focal point in the emotionally intense quest for security, status, and self regard, it has acquired for many individuals an illusion or a 'mystique' which contrasts greatly with the purely utilitarian status accorded to it in traditional economics. This dualism between illusion and practical appears throughout monetary history.

Haines, writing about the money illusion, observes, "While we know that money is a veil behind which lie real production and consumption, we are so accustomed to seeing the pattern on that veil that sometimes we confuse it with the reality underneath. In fact it might be more apt to speak of money not as a veil, but as a pair of glasses through which we continually view the world around us. The glasses themselves are somewhat distorted, but we've been wearing them so long that we see the distortion as if it were an integral part of the landscape".

Thus, an individual subject to money illusion feels better when his wages double even though prices also double and his real wage remains constant. Some economists believe that the effects of money illusion are very strong and that a worker bases his actions to a much greater extent on the level of his money wages than on the level of his real wage. Thus, a worker may refuse to work when his

money wages drop even if prices fall so that his real wage remains the same, but he will not stop working when his money wages remains constant even if prices rise so that his real wage is lower. The effect of the money illusion is to make the supply schedule of labour elastic to changes in the money wage (at a constant real wage) and particularly inelastic to changes in real wages caused by shifts in the price level. The money illusion also has an impact on consumption; an equal rise in wages and prices (leaving the real wage unchanged) having the effect of raising the real consumption level (at least in the short run).

The matter of money illusion is principally a psychological problem; but the economists cannot ignore it. Because the way people feel about money may have important implications for the way they permit it to perform its utilitarian functions. The rational attitude is to give more importance to the purchasing power of money than to the money itself. We recall the German experience of 1923, when a million marks wouldn't buy a postage stamp. When the case is expressed in these terms it is perfectly clear that it is not money that makes us rich. Who wants to have a lakh of rupees if it won't buy anything! Money is, obviously, a means to an end. It serves in a better way when its purchasing power is not allowed to fluctuate violently.

Money in Modern Economics :

Modern monetary theorists discard the classical assumption that the role of money is passive and also that monetary disturbances are infrequent and, therefore, insignificant in the long run. With the growth of economic inter-dependence at national and international levels and the increase in wealth among the highly industrialised economies, economic instability has become a more pressing economic problem in modern times. This has tended to shift the focus of economic theory from the problems of the allocation of resources in a fully employed economy to a concern with short-period determinants of the level of economic activity. There has been increased recognition of the fact that since longer periods are composed of a series of linked shorter periods, short-run instability may have adverse repercussions on economic growth over more

extended periods. The size of the money stock and the changing attitudes of the public and business towards holding and spending money are important determinants of short-run instability, *The starting point of modern monetary theory is that money is inherently unstable.*

J.M. Keynes is credited with having developed a general theory of monetary equilibrium in which such monetary variables as income, consumption, savings and investment play major roles. In his earlier works (e.g., *Monetary Reform*, 1923, and *A Treatise on Money*, 1930) Keynes, guided by the traditional approach, attached significance to money mainly in relation to price levels. With the publication of his *General Theory of Employment, Interest and Money*, (1936), monetary theory became the theory of output and employment as a whole. Keynes considered 'short-run' as a more realistic situation and he once quipped, "In the long-run we are all dead". He held that any decrease in monetary outlays for consumption and investment (or, what amounts to the same thing, total expenditure) would be reflected not only in a decline of the price level, but also and perhaps to a greater extent, in a decline of output and employment. A rise in total expenditure, on the other hand, would raise the levels of output and employment, provided the economy is operating at a level lower than its full capacity. It would affect prices only when the economy approaches its full capacity level.

Keynes had attempted to establish a link between changes in the stock of money and changes in expenditures. For the determination of prices and the level of economic activity, the monetary forces were seen as passive and permissive rather than as active and forceful causal factors. The real causes were traced to the behaviour of saving and investment relationship and its reaction upon economic activity.

In the late fifties, the economists at the University of Chicago led by Prof. Milton Friedman have challenged the Keynesian views. They have insisted that money does matter and, therefore, any interpretation of short-term movements in the economic activity which neglects the role of monetary changes is seriously faulty and misleading. Money in these terms becomes more basic—it is

something which enables people to separate two essential acts; the act of purchase from the act of sale. This separation emphasises the role of money as a "*temporary abode of purchasing power*." This is a direct consequence of considering money as a part of wealth. Money, then, becomes one among many assets which is held by people not as a store of value just as claims over wealth but because it renders extra services. Friedman asserts that money yields real returns in the form of convenience, security and perfect liquidity. It may also yield a money return, say interest earned on saving deposits. The demand for money is determined not only by price and income levels, but also by the cost of holding money. The Chicago economists have found a strong positive correlation between the stock of money and nominal national income and the level of prices.

In modern economics, money has been considered as the most dynamic element in the economy and as "a link between the present and the future". It influences not only the level of prices but also the cyclical behaviour of consumption, savings, investment, and employment. In the modern approach towards money the stability of money is no longer taken for granted, and yet the stabilisation of the value of money is brought into direct relation with the stabilisation of the levels of income and employment. Money being inherently unstable, is not likely to manage itself in the best interests of the economy. It has to be deliberately managed with a view to assisting in the achievement of certain definite socio-economic objectives. A well-conceived and well-executed monetary policy is, therefore, considered as an essential pre-requisite for the stable and efficient working of the national economy.

It is, however, as much dangerous to over-emphasise the role of money and monetary policy in an economy as to under-emphasise it. The size of the national income or aggregate output depends upon the size of real economic resources and such 'real' factors as technological, institutional and structural changes. Money supply cannot make up for any deficiency or scarcity in the factors of production. Nor can monetary policy compensate for a paucity of real resources, or a backward state of technology or inefficiency of labour, or inefficiency in government economic activities. Money supply or monetary policy can help to raise the actual production

curve up to the level of the production possibility curve, but it cannot by itself raise the potentiality of the production possibility frontier itself. Monetary theory is inadequate in explaining the long run behaviour of the economy based largely on real factors. Obviously, monetary analysis alone cannot help in explaining everything that happens in the economic arena. The real economic evils of society— inadequate production and inadequate distribution—actually “lie too deep for any purely monetary ointment to cure”. Monetary policy should, therefore, be supplemented by non-monetary policies. In a way, monetary policy is not a policy in itself, but “a part of one general economic policy, which includes among its instruments fiscal and monetary, measures and direct physical controls”.

Money in Economic Life

Money plays an important role in the shaping of the economic life in a country. Money is characteristic of nearly every highly developed civilization, and we might almost say that it is necessary to such development. Marshall has summed up the idea of the importance of money in relation to economic life by regarding the history of money as synonymous with the history of civilization. Whether our economic life is smooth or disturbed can be understood with reference to our monetary system. The moment money ceases to work smoothly, everything is rendered chaotic. A.C.L. Day has rightly observed that “the major part of the subject-matter of economics is concerned with the functioning and malfunctioning of money”. Similarly, Marshall has said that “money is the pivot around which economic science clusters”.

We know that money influences the rate of aggregate expenditure which can affect not only the price level but also such variables as employment and output. According to Robertson, “The existence of a monetary economy helps society to discover what people want and how much they want it and so to decide what shall be produced and in what quantities and to make best use of its limited productive power. And it helps each member of society to ensure that the means of enjoyment to which he has access yield him the greatest amount of actual enjoyment which is within his reach—it gives him the chance of not surfeiting himself with bus

rides, or stinting himself unduly of the countenance of Charlie Chaplain". Money has, thus, influenced and facilitated in a number of ways all economic activities in the fields of production, consumption, exchange, distribution and public finance.

Money and Economic Welfare : The primary social goals for a welfare evaluation of the operation of an economic system might be maximum freedom of choice for individuals, an equitable distribution of income, and optimum standards of living for all individuals as determined by their preferences and restricted only by available resources and technology. It is obvious that the goals of a welfare economy can be achieved only in a money economy. Money helps the producers and the consumers to spend their resources with some degree of rationality. It also gives them freedom of choice in production and consumption. Money has facilitated achieving high production and employment and wide distribution of benefits at any one time. It is true that the existence of such factors alone does not guarantee economic welfare, but their absence makes it difficult to achieve the goals of economic welfare.

The quantity of money affects economic welfare through its relation to total expenditure. Spending may vary because the money supply varies or because of changes in people's willingness to hold it as a store of value. If total spending is too low, resources will be unemployed and the economy will be depressed, as in the United States and Europe in the 1930s. If spending is too high, price inflation may create its own detriments to economic welfare as in Germany in the 1920s.

Money as a Link Between the Present and the Future :

In discussing money, Keynes tells us: "*The importance of money essentially flows from its being a link between the present and the future.*" And again: "Money in its significant attributes is above all, a subtle device for linking the present to the future. Under the conditions of dynamic equilibrium, as long as monetary expectations are capable of influencing our present day activities so long will money remain a device to link the present and the future". In the words of Keynes: "We cannot even begin to discuss the effect of changing expectations on current activities except in monetary terms.....So long as there

exists any durable asset, it is capable of possessing monetary attributes and therefore, of giving rise to the characteristic problems of a monetary economy". Money as such can take the form of any durable asset capable of performing the store of value function. Largely through this function, money influences the cyclical behaviour of consumption, saving, investment and employment.

Another link between the present and the future is the system of 'forward' and 'future' price on the organized exchanges. All prices, in fact, even present prices of securities, goods and services are links between the present and the future, because they embody and reflect the anticipations of buyers and sellers respecting the future.

Money serves as a link between the present and the future when it functions as a standard of deferred payments. For the value received in the present, payments are made in the future. This becomes possible because of all the commodities, the stability in the value of money is considered to be the greatest. In the field of distribution, money serves as a link between the present and the future when the payments are made to the factors of production today while the commodity produced is yet to be sold.

It may be emphasized, however, that money will link the present with the future in a better way when it is able to maintain relative stability in its value over a definite period of time.

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CHAPTER



CIRCULAR FLOW OF MONEY

A continuous circular flow of money payments is the important characteristic of modern economic life. It can be described in terms of a circular flow of incomes and expenditures in the economy. Most of us play the dual role as producers and as consumers. In the capacity of producers we earn incomes which we spend as consumers on the purchase of goods and services. As owners of productive services we are paid wages and salaries, or we receive income in the form of profits from the business or we get paid for investment we have made. We receive our payments in money which we use to purchase what we need as consumers. As agents of production we create a continuous flow of goods and services from the farm and the factories. This flow is directed mainly towards the consumers. When they make purchases of these goods and services, there is flow of money payments from them to the producers.

For every, flow of factor services, there is a counter flow of money payments in the form of income of the factors of production. For every flow of goods, there is a corresponding counter flow of money payments in the form of expenditure. The money spent by the consumers on the purchase of available supplies of goods and services passes through the hands of retailers, wholesalers and manufacturers. It again comes back to the consumers in the form of

rent, wages, interest, salaries and profits. There is, thus, an unending circular flow of money payments in an economy which gets guidance mainly from the price system in the economy. The main condition for constant flow of goods and services at constant prices is that there should be no leakage's of money out of active circulation. Whatever is paid out to different factors should come back by way of expenditure on goods and services.

If the volume of the factors of production is shown as Q_d and their remuneration or price as P_d , their aggregate sum will be equal to the aggregate money income (Y). Thus, $Y = \sum Q_d P_d$. On the other hand, if the volume of goods and services produced by the factors of production is represented by Q_p and their price by P_p , their aggregate sum will be equal to aggregate money expenditure (X). Thus $X = \sum Q_p P_p$. Since money income is derived out of money expenditure, therefore, $Y = X$ or $\sum Q_d P_d = \sum Q_p P_p$.

In actual practice, all that is earned is not spent on consumption only. A part of the income earned may be saved. Savings represent the amount of money taken out of the money flow and, therefore, constitute a leakage from the circular flow. But these may flow back to the economy in the form of investment. So long as the flow of funds into the capital market (savings) is equal to the flow of funds out into the capital market (investment), the circular flow of money will be maintained without any change in prices and production.

The international trade may also affect the circular flow of money. Imports have to be paid for, while exports represent payments from other countries. An excess of imports over exports will, thus, reduce the money flow, while an excess of exports over imports will increase the money flow. A steady flow of money can, however, be maintained if an excess of savings over investment is balanced by an excess of exports over imports.

In the process of circular flow, some money goes to the government in the form of taxes but this too flows back to the society in the form of public expenditure. Public authorities also enter the capital market both as savers as well as borrowers.

Any disturbance in the circular flow of money may throw the economy out of equilibrium. Stability of prices, income or production,

and sales can be maintained only when the two flows are kept in balance. For ensuring economic growth, it may be necessary to "allow the two flow-streams to operate at a higher level. But they should attain height in equal proportion. If the flow of money payments increases without there being a corresponding increase in the counter flow of final goods and services, it will create an inflationary situation, which is likely to become a cumulative process.

On the contrary, if the flow of money payments falls short of the counter flow of goods and services, it sets in motion a cumulative deflationary trend in the economy resulting in falling prices and employment, smaller national income, and lower production and sales. Given the total supply of money, any attempt to save more than investment, to tax more than public spending, or to import more than exports will result in a reduced flow of money leading to reduced factor incomes and employment and also prices; this will set in motion a cumulative deflationary trend in the economy. On the other hand, an increase in the circular flow of money will create the opposite trend—increase in income, employment and prices. In the interest of economic stability the flow of money should, therefore, be smooth.

Traditional price-system theories assumed that all the incomes created in the productive process would smoothly respent on current production and, thus, the flows of income and expenditure will remain in balance. If it is so, neither inflation nor deflation would occur. It was also assumed that savings tend to be equal to investment and the foreign payments are matched by foreign receipts. Practically, however, there are numerous ways in which the two flows may diverge from each other. It is not possible to believe that there will be complete equality between (a) factor payments and consumption expenditure; (b) flow of funds into and out of the capital market; (c) receipts from exports and the payments for imports; and (d) government's tax revenue and public expenditure. Accordingly, the smooth circular flow of money in an economy with constancy of production and prices will be very difficult to achieve in practice.

There are factors like war, floods, strikes, technological changes, etc., which tend to cause changes in the flow of goods and services without having any simultaneous effect on the flow of money payments. The operation of expansionary monetary and fiscal policies in the economy, on the contrary, helps in increasing the flow of money payments without ensuring a counter flow of goods and services in the same proportion. It becomes essential for the government, therefore, to adopt positive programmes and policies of positive intervention in the economy for the purpose of achieving an ideal balance in these two flows. It is an important responsibility of the government that it should attempt to control and vary the quantity of money and the level of money incomes with a view to producing the best possible pattern of total spending. It is fully recognised that the really important problems of money relate to the stream of money payments rather than to the quantity of money itself.

Money in the Capitalist Economy :

Capitalism or a 'Free-Enterprise System' is an economic system based on the concept of private property, the right of ownership and use of wealth to earn income. From private property comes the institution of private enterprise or production by privately owned businesses. Firms are free to hire, produce and price as they see fit. Furthermore, there is private initiative to carry on production, based on profit-motive. There is perfect freedom of choice, enterprise and contract. A free-enterprise system is, thus, characterised by the very large number of decisions reached independently by producers and consumers. Government activity is limited to a few spheres, such as national defense and police protection, but in matters of production and pricing the Government is expected to take a *laissez-faire* position and exert little or no control. The function of controlling the economy and co-ordinating the many independent decisions is achieved through the operation of a free-price system. The force of competition is expected to be an important factor in assuring the smooth and efficient functioning of the price system. The mechanism of prices determines and directs the flow of goods and services and helps in the distribution of total output as income among individuals

who participate in production. Since prices are expressed in money only, money becomes the life-blood of a capitalist economy. The capitalist economy clusters round the pivot of money.

In a capitalist economy the consumer is free to choose what goods to buy and how much to buy. Normally he will choose those products which yield the greatest utility relative to their price. Apart from the consumer's individual tastes and circumstances, his choice of purchases will depend upon (1) his total money income; (2) the part of his income which he prefers to spend on consumer's goods; (3) the price of the goods and services which he actually purchases; and (4) the prices of other goods and services. The collective decision of the whole body of consumers directs production in a capitalist economy. A producer will produce only that commodity for which there is demand. He can get good price and earn profit by producing in accordance with the consumer's choices or preferences. The volume of production itself depends upon the consumer's attitude towards spending and saving, depending upon the rate of interest. The wishes of the consumers are thus made known to the producers through the mechanism of prices.

Producers and the business firms seek high profits by producing those goods for which selling prices exceed their costs. They will attempt to minimize costs by using each resource where it is most productive. It is used in producing the products most widely demanded and it is assigned to the function in which its productivity is highest. The price of each resource will be equal to the value it contributes to production in the various uses. The price of each product will equal its cost of production. The pricing process on the different markets are, thus, inter-related and "they are supposed to lead to a state of equilibrium in which the economy will remain until it has to be adjusted anew to changes in the data, such as changes in tastes, in technology, or in the supply of the factors of production".

It is, thus, the pricing process that helps in achieving a remarkable adjustment between production and consumption. It determines what is to be produced and in what quantities; allocates economic resources in various productive activities; determines the

share of different factors of production; regulates the flow of saving and investment; brings about an adjustment between aggregate demand and aggregate supply; and equilibrates the demand for and the supply of money. Through the price system the decisions of millions of individuals are reconciled with each other. Specialization and exchange are efficiently organized without any central direction or coercion. The system also provides a continuous sensitive mechanism to adjust to changes in desires, technology, or resource supplies. It all operates through the medium of money.

In the pricing process of the capitalist economy, there are two different, though closely interrelated price movements—relative price movements and the general price movements. From the point of view of regulating production and distribution, relative price movements are more significant. A higher relative price, for instance, encourages more production in and attracts resources to the area of high demand. General price movements, generally caused by an increase or decrease in total monetary demand, affect the economy mainly by disturbing the structure of relative prices. According to Halm, “These general price movements could be a matter of indifference for the economy if it were not for the fact that they are bound to disturb the structure of relative prices.....”. It was mainly this line of thinking which made the traditional economists to believe that relative prices were more relevant to economic policy than the general price level.

It is assumed that reciprocal price relationships tend to bring the economy into an adjustment or “a state of equilibrium at full employment”. This does not mean, however, that there are no disturbing and Disequilibrating forces, which prevent the economy from ever reaching or maintaining equilibrium at full employment. Practically it is difficult to prevent monopoly and private restraint of economic freedom, with the result that the incomes may be unfairly distributed. The private firms will not produce in optimum quantities such products and services as national defense, education, public health, police and fire protection and highways. These will be forthcoming only through taxation and Government spending which is very likely to affect the working of the economy.

But the foremost among the disturbing forces are those connected with the supply of and the demand for money. A free economy is characterised by instability of total expenditure. Whenever the actual amount of expenditure is different from the ideal amount, it is likely to create situations known as inflation and deflation. In practical life even a capitalist economy is far from laissez-faire. Much of the positive Government intervention is intended to make the price system work better. This calls for the regulation of money and total expenditures through appropriate monetary and fiscal policies. In a capitalist economy also it becomes essential to control the dynamic functions of money through government intervention in economic life.

Money in the Socialist Economy :

Some socialist writers argue that where the entire economic activity is planned, controlled and executed by the State there is no necessity of the pricing process and the use of money can be dispensed with altogether. Karl Marx, Lenin and some other socialists have actually expressed great hostility towards money. They have considered money as the fundamental cause for the exploitation of labour by the capitalist or what they call as the 'bourgeoisie'. Karl Marx said in the Communist Manifesto, "The bourgeoisie...has left no other nexus between man and man than naked self-interest, than callous 'cash payment'It has resolved personal work into exchange value....The bourgeoisie has stripped of its halo every occupation hitherto honoured and looked up to with reverent awe. It has converted the physician, the lawyer, the priest, the poet, the man of science, into its paid wage labourers". In Marx's opinion an ideal economy is one where there is no medium of exchange like money and goods are exchanged directly against goods. Marx believed that this could be quite feasible in a socialist economy, which is planned in every detail by the State.

When the Bolsheviks (Russian communists) seized power after the October Revolution in 1917, extensive direct requisition and free distribution of goods were conducted by the Government, which "hoped to effect a transition to a natural economy in which purchase and sale, and the medium with which they were carried out *i.e.*,

money—would have no place”. This was quite in conformity with the belief of the early socialists that money was the symbol of avarice, self-aggrandizement, capitalist exploitation and ruthless individualism, while its abolition would promote economic brotherhood, altruism and political solidarity.

However, the Bolsheviks soon realized that they were mistaken in their belief and that the use of money was inevitable even in a planned socialist economy. In October 1921, Lenin clearly admitted that even the initial stage of Communism could not be achieved without proper calculation and control. Trotsky also admitted. “The blueprints produced by the offices must demonstrate their economic expediency through commercial calculation. Without a firm monetary unit, commercial accounting can only increase the chaos”. Consequently when extensive central planning and collectivization were undertaken in the late 1920s and the New Economic Policy was adopted in 1921, the system of money and banking was accorded an important role in the working of the economy.

In Soviet Russia, the Supreme Economic Council prepared two types of plans : (i) the production plan, and (ii) the financial plan. The former was prepared in physical terms; and the latter in terms of money, which served as a guide to prices, taxes, government loan policies, *etc.* The pattern, the volume and the technique of production were determined and controlled by the state and not by the price system. However, production and income transactions were carried on by means of money. Wages and salaries were paid in money, which the recipients were free to spend on whatever products were available. The transactions between different production units were carried on in money mainly through deposits with banks. Managerial policies were influenced by the consideration of revenues, costs and prices. Efficient managers were those who could maximize the difference between money costs and money revenues. Obviously, money was relied upon as a standard of value and as a medium of payments, but the price system did not provide the kind of guidance to production and distribution that it does in a free market economy as it was subordinated to the decisions of the central planners.

Why have the Russians and other Socialists found money so indispensable? Trescott has cited following four reasons:

- (1) A desire to use money wages to allocate labour and spur incentive.
- (2) The convenience of money for the distribution of particular goods to particular individuals.
- (3) The desire to use the profit motive as a test of and spur to managerial efficiency.
- (4) Recognition of the usefulness of the banks as additional checks and controls on the managers of industrial firms.

Besides the above, there are some more reasons :

- (1) The use of money is inevitable as a standard of value and as a means of payments in any exchange economy.
- (2) The determination of priorities involves the comparison of relative usefulness of allocation of limited economic resources to different fields of employment. This can be done with the help of prices, which are expressed in terms of money only.
- (3) The existence of money gives some freedom of choice to the consumers even in a socialist economy.
- (4) All the economic calculations can be conveniently made in terms of money only. As A.P. Learner has pointed out, without a pricing system based on money "it is impossible for an economic system of any complexity to function with any reasonable degree of efficiency".
- (5) Some socialist economists like Oscar Lange, argue that all the advantages of the price system can be achieved only in a socialist economy. It is argued that controlled price-mechanism under socialism would serve as an efficient guide to economic activity, avoiding at the same time, the distortions resulting from private monopoly and property incomes.

In recent years, the use of controlled price-mechanism has been given importance in communist countries in determining the

allocation of resources in accordance with the preferences of consumers.

It is true that money is not as much important in a socialist economy as it is in a capitalist economy. While it is a master in a capitalist economy, it is only a servant in a socialist economy. But it is an indispensable servant who helps in a number of ways. It is obvious, therefore, that whatever type of economic system we choose for ourselves, money is going to be significant for us. Halm has rightly said, "Social economy will remain a monetary economy".

Money in a Developing Economy :

A developing economy is one where people are beginning to utilize available resources in order to bring about a sustained increase in production of goods and services. It can be stated in general terms that economic development controls (a) a rise in *per capita* income through time; (b) a gradual transformation of the subsistence sector, which is a distinguishing feature of an underdeveloped economy, into monetised sector; and (c) increasing institutionalization of saving and investment. Each one of these aspects has a direct relationship with the use of money in a growing economy.

Although economic development is governed, in the final analysis, by the 'real factors' such as saving-investment, productivity of capital and labour, population, *etc.*, the role of money is crucial in determining its speed in view of the monetary manifestation of the growth process. In a free or partially planned economy, decisions to save and invest, when they are mediated through the use of money, are largely affected by attitudes and motivations of the spending and investing units towards money as an asset. The pervasive influence of money tends to increase the proliferation and diversification of financial assets which are the consequences of a gradual separation of those who save from those who invest.

The reasons why money plays such an important role in the growth process are easy to understand. For one thing, the economy using money takes on an impersonal character. Savings remain no

longer dormant in separate pockets for want of necessary matching investments; money helps to transmute them into monetary form available to anyone willing to pay the price. Thus the use of money obviates, at one sweep, all the obstacles arising from space and time. For another, money brings up to the surface all the price relationships in all their entirety which leads to optimum utilisation of resources. In other words, all that money does in a growth process is that it provides “an efficient payments mechanism” and guides “qualitatively and quantitatively the flow of funds to economic units whose aggressive spending is stimulating real output and the flow of financial assets to economic units whose restraint on spending frees resources for real investment”.

What then is the precise role of money in a developing economy? Money is not a real factor of growth. But it plays a catalytic part in speeding up the process. Money may be conceived to be a causal factor in economic development in so far as its availability induces a regular and balanced expansion of the economy. In this sense, money discharges the function of a catalytic agent. The statistical series concerning the United States for about a century seem to suggest a significant relationship between changes in the stock of money and changes in economic activity. Money is, thus, more of a transmuting agent, which tends to galvanize the whole process of development. If, for instance, money is totally absent in the economic system, the crucial variables influencing growth would remain tethered and thus the growth would not be as fast as it would be otherwise. The monetary policy in a developing economy should, therefore, aim at regulated expansion of money. Its supply must expand with national output.

It is obvious, therefore, that whatever type of economic system we choose for ourselves money is going to be significant for us. Halm has rightly said, “A social economy will remain a monetary economy”.

Money : Blessing or Bane?

Money helps the society in so many ways that it seems to be a source of blessing to mankind. Actually, money is a source of economic fluctuations and disturbances also. The evils of money

are so serious that some have described money as a source of 'bane' or curse and not a 'blessing'. It is observed, "Money is the epitome of paradox. It is at once the most and the least important of economic goods". The fact, however, is that money is not all-important: neither is it unimportant. Money is not an evil, nor is it an unmixed blessing. We have to maintain a balance between the two extremes. There is no denying the fact that money plays a significant role into economic life. But the functioning of money in its roles is impaired when it is mismanaged or improperly controlled resulting in instability in its value. Robertson has rightly observed; "Money which is a source of so many blessings to mankind, becomes also, unless we can control it a source of peril and confusion".

We know that money is only a means or a tool. Properly used it may indeed be a blessing. Sometimes it may be used for purposes for which it was not intended. It is only in the latter case that the use of money creates difficulties and disturbances. Some of the dangers arising mainly out of the misuse or mismanagement of money are given below :

1. Instability in the value of money not only impairs its functioning in different roles, it also creates many difficulties for different sections in the society at different times. The changes in the value of money are reflected by inflationary and deflationary situations. These situations are not only socially disastrous in many ways but also disrupt production and distribution and create maladjustment's in the structure of capital goods and in industrial organization.
2. The processes of inflation and deflation generally become a cumulatively worsening process, which help in the creation of business cycles. It is true that business cycles can be caused by non-monetary factors as well. But this does not mean that monetary factors are a lesser potent cause for creating business cycles.
3. In a free economy, money is arbitrarily concentrated in the form of wealth in a few hands. Its owners get a peculiar industrial and social power, a kind of monopolistic

advantage which they use to exploit the weaker sections of society. By using money as a medium of payments in international trade, the strong nations manipulate the exchange rates in their favour and exploit the weaker nations.

4. The uncontrolled use of money widens the inequalities of income in the society and creates class conflicts between the 'haves' and the 'have notes'. Even at the international level, there are conflicts and clash of interests between the rich and the poor nations, the capitalist and the socialist or semi-socialist nations.
5. Money promotes extravagance in consumption expenditure and over-capitalization and over-production in the field of production. This sort of misuse of the facilities provided by the monetary system is apt to lead to grave set-backs and let loose destructive forces in the economy.
6. Moral and ethical considerations have been sacrificed at the altar of money. It is interesting to quote Mises, "Money is regarded as the cause of theft and murder, of deception and betrayal. Money is blamed when the prostitute sells her body, and when the bribed judge prevents the law. It is money against which the moralist declaims when he wishes to oppose excessive materialism. Significantly enough, avarice is called the love of money, and all evil is attributed to it". Money has corrupted every social and political institution. In the words of Ruskin, "The devil of money has come to possess their souls. No religion or philosophy seems to have the power of driving it out".

All the evils discussed above arise out of misuse or mismanagement of money. Money itself is not bad, but it produces bad effects when it is improperly used. Fire is one of the greatest of man's inventions, but unless properly used and controlled it destroys our homes and brings devastation. Similarly money may be misused by the individual or mismanaged by the economy as a whole. Walter Bagehot (1826-1877), a noted financial writer, had rightly said that "money will not manage itself. The modern

economists have emphasised deliberate management and control of money by the government with a view to achieving certain well-defined objectives. Keynes advocated monetary management for achieving full-employment in the economy. The main idea underlying monetary management is “first of all, that the government should prevent the money supply from being an active cause of undesirable changes in spending. Second, the government should try to manipulate the money supply so as to reduce or eliminate undesired fluctuation in total spending arising from private spending decisions”

However, monetary analysis alone does not help in explaining everything that happens in the economic life. According to Prof. Robinson, it is essential to “examine the effects exercised upon the creation and distribution of real economic welfare by the twin facts that we do use the mechanism of money and that we have learnt so imperfectly to control it”. It is essential, therefore, that for a realistic understandings and practical solution of economic problems, the economic analysis should be made not only in monetary but in real terms also.



CHAPTER



VALUE OF MONEY

The concept of value is ordinarily used in economics to show value in exchange. That is, the exchange value of a goods or service is expressed as the quantity of other goods, which must be exchanged to obtain one unit of the given goods. The marginal utility theory of value holds that the exchange value of an economic goods depends on the utility rendered by the last unit of the goods consumed, thus combining the concepts of desirability and scarcity. Money, however, differs from other goods in the sense that it possesses no direct utility and it is not demanded for its own sake. While other goods possess independent utility, money's utility to its possessor flows from its capacity to buy other goods and services, which have utility in themselves. The utility of money is, thus, derivative. It is solely derived from its exchange-value, that is to say, from the utility of the things, which it can buy. The value of money lies not in its direct utility, but in its buying capacity.

Concept of the Value of Money :

Since money is ordinarily used as the measure of value, the exchange values of other economic goods or service are usually expressed in terms of money. Money is the common denominator for comparisons of the exchange-values of all goods and services.

But to express the value of money in terms of itself would be meaningless; a rupee is obviously equal to a rupee. In what terms should we express the value of money?

By the term 'value of money' is meant the purchasing power of money, the ability of each unit to command goods and services in exchange. All that can be purchased by a unit of money is the value of money, in the same way as the value of a good is expressed as the quantity of money, which it commands in exchange.

However, that the value of money couldn't be determined or indicated in terms of any single commodity or a group of some goods. It is expressed in the form of all the goods that can be purchased by it. It refers to the *general* purchasing power of money, *i.e.*, the amount of goods and services in general which a unit of money can purchase at a particular time. According to Robertson, therefore, by value of money "we mean the amount of things in general which will be given in-exchange for a unit of money".

The larger the quantities of goods and services which a unit of money can buy, the higher is its value and *vice-versa*. Obviously the value of money is closely related to the prices of goods and services. It is, in fact, the reciprocal of the level of prices. When the price level is high, the value of money—the ability of each unit to purchase goods and services—is low. And when the price level is low, the value of money is high. This inverse relationship between the level of prices and the value of money can be expressed in algebraic terms:

Since money buys anything and everything that has a price, the value of money should be expressed in terms of all goods or all prices. But here we encounter a practical difficulty. In view of the fact that there are innumerable goods and innumerable prices in the world, to express the value of money in terms of all things or all prices taken together is neither feasible nor useful. This difficulty is overcome by taking into consideration the *general level of prices*. By averaging prices of all goods; like and unlike, important and unimportant, we might get a fairly accurate idea of the value of money.

A rise or a fall in the general level of prices does not mean that the price of each and every commodity has risen or fallen in the same proportion. In fact, the general level of prices denotes the central tendency of a group of prices. A rise in the general price level implies that in general the prices of goods and services are rising. In reality, prices of certain goods might have not risen or might have even fallen. Thus, general price level is indicative of general or average tendency of prices.

The concept of general price level is, however, beset with some practical difficulties. The general level of prices is based on a hotchpotch of the price level of all sorts of goods. It has little meaning for an individual who, at a particular moment of time, is interested only in a certain collection of goods and services that are of utility for him. The purchasing power of his money is, obviously, affected by the prices of only those goods, which he wants to purchase. He will, therefore, try to reckon the value of his money in terms of such goods only. Thus, the value of money is not the same for every individual when he is out to spend it. Keynes expresses his disapproval of concentrating too much on the general level of prices and emphasizes what he calls "Plurality of Secondary Price Levels".

Hayek has criticized the concept of general price level and has considered the movement of relative or individual prices as of greater significance. He remarks that "the problem is never to explain any general value of money but only how and when money influences the relative values of goods and under what conditions it leaves these relative values undisturbed".

Monetary theory often runs in terms of the relation between the quantity of money and the general price level. This has grown out of the belief that monetary changes affect only the general price level and that the relative prices remain dependent upon the play of real factors, *i.e.*, conditions of demand and supply of individual goods or individual groups of goods. It is true that, in the long-run, changes acting on the money side do tend to diffuse themselves over all goods but it is also equally true that a change in the quantity of money by itself may affect different groups of goods differently, the process depending upon the channel through which the

additional money passes into the economy. Thus, even in those cases in which the rise of the general price level is initiated by an enlargement in quantity of money, all individual prices are not affected uniformly. Some respond quickly and advance rapidly, while others respond only after a delay and advance slowly; and the more rapid the rise of the price level the greater, in general, is the dispersion of individual prices. It is precisely because of this non-uniformity in the behaviour of individual prices that changes in the value of money are capable of exerting such far-reaching effects on (1) the distribution of real wealth and income, and (2) the volume of employment and production.

It is misleading, therefore, to concentrate on general price level alone and to neglect relative price movements. It may not be possible to agree fully with Hayek when he goes to the extent of discarding the concept of general price level altogether and takes only relative price movements into consideration for developing his theory of trade cycle. But there is no denying the fact that along with the study of general price level, the range of dispersion of relative price levels around the general price level is itself an interesting and important study. As every change in price interrelations has its production and distribution effects, the really important role of relative price appears when the price system is regarded as a steering mechanism for attaining pre-defined ends of securing a desirable allocation of production and consumption currently. The distorted relative prices may have the tendency to move resources away from the uses that have a higher priority from a social and economic point of view. It is important, therefore, that for the purpose of formulating a suitable price policy due consideration may be given not merely to the aggregate or general price level but also to the relative level of prices.

Crowther holds that there are an infinite number of different values of money according to the uses to which it is put. He observes, therefore, that "he phrases the 'value of money' without qualification is almost meaningless". Any exact definition of the value of money, according to him, must necessarily be a somewhat complicated or difficult affair. The only practical way to get over this difficulty is

arbitrarily to establish certain standard values of money. Crowther has distinguished three standards of the value of money : (i) *The Wholesale standard*, (ii) *The retail standard*, and (iii) *The Labour Standard*.

It is the wholesale value of money that matters much to the producers and the traders. The consumers are interested in the cost of living or consumption (retail) standard value of money. Similarly, entrepreneurs who hire every variety of labour would be interested in the labour value of money only. It is, thus, the movement of sectional price levels, relatively to one another, that affects the economy as a whole and the fortunes of different groups of people. In view of such infinite variations and sectional interests, it becomes difficult to give an exact definition of the value of money. Crowther has, therefore, attempted to define three different values of money. But these are very arbitrary definitions, based on arbitrary assumptions. He justifies his attempt by saying that "when there is such infinite variation, some degree of arbitrariness is necessary".

Measurement of Changes in the Value of Money :

Even with the narrowed-down arbitrary conceptions of the value of money (*viz.*, wholesale standard, retail or consumption standard and labour standard), it is not easy to measure the value of money in any of its standards. Any attempt to write down the value of money in any of its standards requires the preparation of lengthy and unwieldy lists of various goods whose prices are quoted in the wholesale, retail and the labour markets. Indeed, to prepare such a list is a complicated task. Such a lengthy list so prepared may be accurate, but it would be virtually useless and incomprehensible for the purpose of measurement of the value of money. Hence we cannot find out really what is the wholesale, the retail or the labour value of money.

It must be admitted, therefore, that the value of money in absolute terms cannot be measured. In practical life, we are actually concerned more with the measurement of changes in the value of relatively to other periods, rather than its absolute value. We are interested in finding out whether the value of money is more or less than it was

last month, or last year, or ten years ago. Crowther aptly remarks, "What needs to be measured is not so much the value of money itself as changes in the value of money".

We can measure only the relative changes in the value of money over a period of time; but not the value of money in any absolute sense. All we can do is to compare the purchasing power of money in one period with its purchasing power in another period. Even this measurement is done indirectly, by comparing the price level at one time with the price level in an earlier period. This can be done by the statistical device known as —index numbers'.

Index Numbers :

Index number is a measure of the relative changes occurring in a series of values compared with a base period. It measures the relative change of a variable over a period of time. Comparisons are usually made over periods of time; but index numbers may also be used for comparisons between places and categories. Index numbers are, thus, series of figures by which changes in the magnitudes of a phenomenon are measured from time to time or from place to place. There are various types of index numbers in terms of what they measure. Broadly, three types of index numbers are generally prepared. (i) Price index numbers, (ii) Volume or Quantity index numbers, and (iii) Special-purpose index numbers.

Money measures changes in the values of goods, but changes in the value of money itself are measured by means of index numbers of prices. "An index number of prices," as defined by Chandler, "is a figure showing the height of average prices at one time relative to their height at some other time that is taken as the basic period". Price indices or the index numbers of prices can be constructed in how the behaviour of many types of price averages. Among those most widely used are indices of (1) the general level of the prices of all goods, services, and securities sold for money; (2) *retail prices* (3) wholesale prices; and (4) the cost of living. The choice of a particular index number depends upon the purpose which it has to serve. For instance, if our purpose is to study the effect of price variations on real and money wages of the workers, we may have to prepare a retail price index or the cost of living index. (In India, it is known as

the 'Consumers 'Price Index'). The wholesale price index will serve the purpose if we have to study changes in the value of money for the businessmen and the producers. An economically relevant definition of price level cannot be independent of the purpose in mind, and for each purpose a separate index number may be constructed.

Construction of Price Index Numbers :

An Italian, Giovanni R. Carli, is generally credited with inventing index numbers. He had prepared a price index for 1750, taking 1500 as the base year. It was, however, not until 1860 that the use of index numbers was made extensive. For the measurement of changes in the purchasing power of money, it has been used by economists like Jevons, Marshall, Irving Fisher, Walsh, Edge-worth, Mitchell and others.

In the construction of index numbers, a base year is selected and the prices of a group of goods in that year are noted. The index number for the base year equals 100, and any changes from it are shown as percentage variations from the base year. The following steps are involved in the construction of index numbers:

1. Selection of Base Year : The year taken as the base should be selected carefully, because we compare the prices prevailing in this year with the prices prevailing in subsequent periods. As far as possible, it should be a normal year. In the words of Crowther, "Any period will do, but it is necessary to have some base with which later prices can be compared just as every map maker must have a datum-line to which he can refer altitudes".

In India, we have been changing the base years for the preparation of index numbers of wholesale prices from time to time. From January 1, 1977, we had shifted the base year from 1961-62 to 1970-71. A new series of wholesale price index numbers with base 1981-82= 100 has been introduced from July 1, 1989.

2. Selection of Goods : The choice of the goods whose prices are to be taken into account depends upon the purpose of constructing index number. For example, if we are preparing a cost of living index number, we must select only such goods as are generally consumed by the working class. As to the number of goods

to be included, it should neither be too small nor too large. Irving Fisher believes that the number of goods selected for the purpose should not be less than 20, "and 50 is a much better number".

The 'All Commodities' index number of wholesale prices in India comprises 447 goods as against 360 in the earlier series, classified into three groups and 16 subgroups.

3. Collection of Price Quotations : The collection of price quotations of selected goods both in the base and the subsequent years is another important step in the construction of index numbers. It is essential that the selected prices should be representative of a large volume of transactions, otherwise a discrepancy might occur. If the index number relates to the workers' cost of living then the retail prices should be reckoned. If the objective is to show changes in the general price level, then we should take wholesale prices into consideration. We shall also have to choose the representative markets from where the relevant information about current prices is to be obtained.

4. Calculation of Price Relatives : Representing price index for the base year by 100, changes in the prices of selected goods in the year of inquiry are represented in the form of price-relatives. Price-relative shows the percentage variation in prices in the year of inquiry or current year in comparison to the base year. Thus,

$$R = \frac{P_1}{P_2} \times 100 \text{ or}$$

$$\text{Price - Relative} = \frac{\text{Current year's Price}}{\text{Base year's Price}} \times 100$$

For example, if the price for wheat in the base year is Rs. 50 per quintal, which rises to Rs. 125 per quintal in the current year.

the price-relative will be 250. $\left(\frac{125}{50} \times 100 \right)$

5. Selection of the Average : Since price-relatives for some goods might be lower than 100 and for others higher than 100, it

becomes necessary to work out the average of all the price-relatives. Different methods can be adopted for averaging. Irving Fisher has mentioned 96 main and 38 supplementary formulae that give correct results within a fraction of one per cent. However, two most common methods are to find out the arithmetic average or the geometric average. Ordinarily, we use arithmetic average which is arrived at by adding up the price-relatives and dividing the total by the number of items.

6. Assigning Proper Weights : The index number may be simple or weighted. Simple index number is based on the assumption that all the goods are of equal importance. But practically it is not so. The goods like salt or sugar are not as much important as wheat or rice for consumption. In order to express the relative importance of different goods, weights are assigned to different goods according to their importance in the scheme of consumption. Weighted index number is arrived at by multiplying the price-relatives by the weights assigned to individual goods. Weighted average is obtained by dividing the total of weighted indices by the total of weights. Weighted average gives a more accurate result in comparison to a simple average.

Example :

In the tables given below we have constructed simple and weighted index numbers of prices. The tables are based on hypothetical data.

Table I. Simple Index Numbers of Wholesale Prices

Goods	Prices in the Base year P_0	Index Number of the base year	Prices in the current year P_1	Index Number for current year $R=P_1P_0 \times 100$
	Rs.	Rs.		
1. Wheat	80	100	240	300
2. Rice	140	100	280	200
3. Pulses	125	100	250	200
4. Sugar	150	100	375	250
5. Salt	8	100	20	250
$N=5$		500		$\Sigma R = 1200$

Index number for current year equals $\Sigma R/N$, where Σ (Sigma) denotes the sum of, R stands for price-relatives and N represents the number of goods. If P_1 shows the price in the current year and P_0 in the base year and N represents the number of goods included in the index, then the average of price-relatives or the average index number will be found out in the following manner :

$$\frac{P_1'/P_0' \times 100 + P_1''/P_0'' \times 100 + P_1'''/P_0''' \times 100 \dots P_1n/P_0n \times 100}{N}$$

Index number of current year = $1200/5 = 240$. The average index number for the base year ($500/5$) remains 100. The average rise in prices between the base and the current year = $240 - 100 = 140$ percentage points.

The average weighted index number for the base year remains 100. Weighted index number of the current year equals $\Sigma R_w/\Sigma w$, i.e. Total of weighted indices. Total of weights. Thus, $4900/20=245$. This shows that according to the weighted index the price level in the current year has increased by 145 percentage points over that of base year.

Table II. Weighted Index Numbers of Wholesale Prices

Goods	Weights w	Prices in the base year P_0	Index Number of the base year	Prices in the current year P_1	Index Number for current year $R \times w$
		Rs.	Rs.		
1. Wheat	7	80	$100 \times 7 = 700$	240	$300 \times 7 = 2100$
2. Rice	5	140	$100 \times 5 = 500$	280	$200 \times 5 = 1000$
3 Pulses	4	125	$100 \times 4 = 400$	250	$200 \times 4 = 800$
4. Sugar	3	150	$100 \times 3 = 300$	375	$250 \times 3 = 750$
5. Salt	1	8	$100 \times 1 = 100$	20	$250 \times 1 = 250$
	$\Sigma w=20$		$2000/20=100$		$\Sigma R_w=4900$

Table I is a specimen of simple index number in which all the goods included are considered to be of equal importance. Practically, however, the importance of all the goods is not equal. It is wrong to assume that salt is as much important as wheat. Any rise or fall in the prices of wheat would affect the consumer substantially whereas he is not so much affected by the changes in the prices of any of

other goods included in the Table. It becomes essential, therefore, to assign weights to different goods in accordance with their importance for the consumer in general.

In Table II weights have been assigned to different goods which indicate the relative importance of these goods in the consumer's budget. It may be seen from the tables that the simple index numbers show an average rise of 140 between the base and the current years, whereas the weighted index numbers for the same goods show an average price rise of 145 during the same period. The percentage rise arrived at by weighted average is evidently considered as more accurate than the one arrived at by simple average.

There are following two types of weights :

1. *The Quantity weight*, which is represented by q . It is based on the quantity in the base year (q_0), or in the current year (q_1) or a sum or average of both.

2. *The Value weight*, which is represented by P_0q_0 because it is generally derived by multiplying price of each item in the base year with its quantity in the base year. Sometimes the price in one period may also be multiplied with quantity in another period.

There are following two methods of constructing weighted index numbers:

1. *Weighted Aggregates of Actual Prices* : Each item included in the index is weighted by the quantity (q) of its production, consumption or sale. When the quantity in the base year (q_0) is multiplied with price in the current year (P_1), its sum $\Sigma(P_1q_0)$ shows current year's weighted aggregate. Similarly, base year's weighted aggregate or $\Sigma(P_0q_0)$ derived by multiplying quantity in the base year with price in the base year. Weighted index is the percentage of variation between the base year and the current year's weighted aggregates.

2. *Weighted Average of Relatives Method*. The price-relative (R) is multiplied with the value-weights (Rw), whose sum (ΣRw) is divided by the aggregate of weights ($\Sigma w = 2P_0q_0$) and this gives the weighted index number. This method is also known as Family Budget Method.

Difficulties in Measuring the Changes in the Value of Money :

We know that the changes in the value of money can be measured with the help of price index numbers over a period of time. But the measurement of changes in the value of money is not an easy task. There are various difficulties to be encountered while doing so. These difficulties are (1) conceptual or theoretical difficulties, and (2) practical difficulties in the construction of price index numbers.

Conceptual Difficulties :

1. The 'value of money' is generally defined as the reciprocal of the general price level. The changes in the value of money are thus to be measured by corresponding changes in the general price level over a period of time. But the concept of general price level itself is abstract and purely theoretical. The general price level implies inclusion of all prices but practically we cannot include all the individual prices in it. We take up sectional price levels only and prepare different indices for different sectional average price levels, such as wholesale price indices, cost of living indices, etc. These indices reflect different changes in the value of money at different times and in different places. Obviously, it becomes difficult to know the exact position. The different indices for different sectional prices are not comparable.
2. The basis of comparison is vitiated by the fact that neither the relative expenditures upon different goods remain the same from year to year nor the content and quality of a commodity remain unchanged.
3. Changes in the value of money are ordinarily measured through wholesale price index numbers. In practice, the consumers or the general public do not make purchases from the wholesale markets. They are affected more by changes in the retail prices from place to place, and most probably at the same place, which cannot be measured accurately.

4. The general level of prices is indicative of average prices only. A rise or a fall in the general price level does not mean that the price of each and every commodity has risen or fallen to the same extent as indicated by the general price index. As a matter of fact, general price index may vary even when there has been no change in the prices of certain goods. Obviously, it does not reflect the correct position. In a strict sense, thus, the concept of general price level is theoretically inadmissible.

Practical Difficulties : The construction of index numbers is beset with several practical difficulties, which make it impossible to have a perfectly accurate measurement of the value of money. J.M. Keynes had remarked in 1930, "Hitherto no official authority has compiled an index number which could fairly be called an index number of purchasing power." Some of the practical difficulties are mentioned below:

1. *The Index Number Problem :* The difficulty relating to the decision of representative goods and weights has been termed as 'the index number problem' by Prof. Benham. It is a known fact that all classes of people living in a particular country do not purchase the same goods. Their purchases differ according to their needs, tastes, habits and income. Since these factors do not remain the same forever, the same individual may change his pattern of consumption and purchases over a period of time.

It is not essential that the goods, which were consumed in the base year, will be consumed to the same extent in the year of comparison also. Many new goods may come into existence and some of the old goods may disappear. The quality and the quantity of the goods may change from time to time. Income and other factors may change the consumption pattern of the people and indices compiled for a period of time may become non-comparable. Benham has rightly remarked that "comparisons between times or places in which the collection of things sold for money are markedly different, have little significance". Keeping this difficulty in view, Marshall had suggested the use of Chain Index Numbers.

2. *Difficulty in the Selection of the Base Year* : In selecting the base year there are several points to be kept in view. In order to avoid bias, the year selected, as the base should be normal. The difficulty is that no year is perfectly normal in all respects. Even if a particular year is selected as base year, it cannot serve the purpose for all time to come. The base period should not be too far in the past since relative prices and the pattern of purchases tend to change over time. In order to flatten out the abnormal prices in one year, it has been suggested that an average of prices of a number of consecutive years, rather than that of a single year, may be adopted as the base price.

3. *Difficulty in Selection of Goods* : The selection of representative goods out of an unwieldy list of goods present a real difficulty. The required number of goods is to be selected according to the purpose and the type of the index number to be constructed. In selecting these goods, it may be kept in view that the items selected should be representative of the taste and habits of the people.

The number of the items should neither be too large nor too small. They should be such as are not likely to vary in quality over different periods and places.

4. *Difficulty in Obtaining Accurate Price Statistics* : It is not always possible to get accurate information about prices. It is comparatively easy to secure information about wholesale prices. But retail prices are more relevant from the point of view of consumers than any other prices; and retail prices are rather elusive. The difficulty is enhanced if the actual market prices are different from the controlled prices of certain goods. Inaccuracies creep into an index number also because price quotations are taken only at important centers and at fixed intervals. Thus, changes in prices at other times and places are ignored. To that extent the data collected are unrepresentative and inadequate.

5. *Difficulty in Assigning Weights* : We cannot scientifically determine the weights to be assigned to different goods, because the importance of a commodity varies from consumer to consumer. It is suggested that this difficulty can be solved to some extent by adoption of 'equivalents', postulating a given quantity of some

commodity as equivalent to a given quantity of some other commodity of the same category. But clearly no such comparisons, are really satisfactory and personal judgement is bound to creep into an arbitrary decision. Index numbers based on arbitrarily determined weights do not provide correct and unbiased conclusions.

6. *Difficulty of Employing a Proper Method of Averaging* : There are various methods of averaging and the use of different methods gives different results, thereby making comparisons difficult. Some statisticians recommend the geometric mean, while others prefer arithmetic average. A large majority of Statisticians support the use of a weighted arithmetic mean.

It is evident from the above account that index numbers suffer from a number of shortcomings. Some of these can be removed to some extent by improvement in the statistical techniques. For instance, non-comparability of the index numbers when the base periods are reversed can be removed by means of reversal tests and construction of ideal index numbers. Difficulty of comparison due to entry of new items and withdrawal of old ones can be removed by the system of chain index number as suggested by Prof. Marshall. However, all the difficulties cannot be removed by mere improvement in statistical technique. Many difficulties still remain to be faced while constructing index numbers. It was an over-statement when W.T. Foster, in his preface to Irving Fisher's '*The Making of Index Numbers*' remarked: "An Index number may be so dependable that the instrumental error probably seldom reaches one part in 800 or less than 3 ounces on a man's weight." In the face of many difficulties and inaccuracies in the construction of index numbers, we can simply treat them as mere approximations. The measurement of changes in the value of money between times and places through index-numbers can give only a rough or an approximate idea of the changes in the value of money.

Uses of Index Numbers : It is true that the index numbers are mere approximations and that they suffer from certain shortcomings. Even then their importance in economics cannot be minimized. Index numbers are known as 'Economic Barometers' because they

help us in analysing the existing trends in the fields of production, prices, income, trade and employment, etc. They guide us in the formulation of suitable policies for the solution of our economic and social problems. For example, the cost of living index numbers help the authorities in the adjustment of salaries and wages. General price index numbers guide the business community and the government in offsetting or counter-acting the effects of fluctuations in the general price level. The use of index numbers is not confined to the measurement of prices only. They provide us with a device for measuring the relative changes occurring in a series of social and economic factors. By the use of an index number, large or unwieldy data are reduced to a form in which they can be more readily used and more easily understood. Obviously we cannot do away with index numbers. It is, however, essential that we should prepare the index numbers as much carefully as possible. As regards the price index number, the best index number, in the opinion of W.I. King, is that which covers a wide list of representative goods; presents a combination of short-term fluctuations and price trends; and in accordance with the changes in production and consumption, revises the quantity of goods from time to time.

Price Index Numbers in India : The index numbers of wholesale prices in India are compiled by the office of the Economic Advisor, Ministry of Industries, Government of India. These index numbers were first introduced in India in 1942. The base year of the index numbers was August 1939 for the period 1942-3955. From 1955 to 1969, the index numbers were prepared by taking 1952-53 as the base year. In 1969 the base year was updated to 1961-62. From January 1, 1977, the base year for calculating the wholesale price index numbers was brought forward from 1961-62 to 1970-71. The base year 1981-82 was introduced from July, 1, 1989. The revision became necessary taking into account the structural changes that had taken place in the economy during the decade 1971 to 1981.

Computation of wholesale price index is based on the 'Laspeyre's Index, i.e., the weighted average of price relatives (current price divided by the base year's price) with base year's quantity as fixed weight. Weights are assigned to the goods/sub-

groups/major groups on the basis of the value of the wholesale market transactions at the time of changing the base year, which remains valid till the next revision is made.

The 1981-82 series index number included 447 goods, as against only 23 in the 1942 index, 218 in the 1961-62 series, and 360 in 1970-71 series. The number of quotations had also gone up from 774 in the 1961-62 series to 2,371 in 1981-82 series. As far as possible, all goods with a value of transaction of more than Rs. 1 crore for which wholesale prices were available on a regular basis, were represented in the index. The weights for the revised index were worked out on the basis of the value of transactions of goods.

In the 1981-82 series, goods were classified as (1) primary articles; (2) fuel, power, light, and lubricants; and (3) manufactured products. The grouping was done according to the Standard Industrial Classification and not according to the Standard International Trade Classification, as was the case in the 1961-62 series. This change was made in order to bring about greater uniformity in the classification system among wholesale price index, the agricultural production index and the industrial production index numbers.

The new series of wholesale price index numbers with base 1993-94 = 100 was introduced in April 2000. The classification of major groups of goods remains unchanged. The new series has 435 items in the commodity basket as against 447 items in the 1981-82 series. The number of price quotations has decreased from 2371 on the earlier series to 1918 in the new series. In the new series, primary articles have 98 items; fuel, power, light and lubricants 19 items and manufactured products have 318 items. Weights allotted to three major groups are 22.025, 14.226 and 63.749, respectively.

‘Consumer price index numbers for industrial workers’ at different centers and ‘Consumer price index numbers for agricultural labourers’ in different states are compiled by Labour Bureau, Ministry of Labour. The Central Statistical Organisation’ compiles the ‘Consumer price index numbers for urban non-manual employees.’

The aggregation of the All-India index is done as a weighted average of respective center-wise or state-wise indices. The current series of consumer price index for industrial workers includes 260 items covering 70 selected industrial centers. Base year is 1982. The index for urban non-manual employees is computed on the basis of the family living survey in 59 selected industrial centers. 1984-85 is taken as the base year. The index for agricultural labourers covers 442 villages spread over 39 agricultural labour inquiry zones of various states. The base year is 1986-87 (July- June).

Index numbers of security prices (both 'All-India' and 'Regional') are compiled by the Reserve Bank of India. These include government and semi-government securities, debentures of joint stock companies, preference shares, and ordinary shares of processing and manufacturing and other industries.



CHAPTER



KINDS OF MONEY

We should bear constantly in our mind the distinction between the *supply* or *stock* of money and money *flows*. The supply of money is simply the stock of those things that are used as a medium of exchange or means of payments, the size of this stock being measured in terms of the country's unit of account or unit of value. Thus, the money supply is stated as the stock in existence at a point of time. This stock may, of course, be increased or decreased from one point of time to another. On the other hand, money spendings or expenditures are *flows* per unit of time. These flows are usually expressed at annual rates. Thus, we might say that spending for American output is at an annual rate of \$500 billion. We may state these flows at annual rates even though we are speaking of a point of time. For example, the statement above that spending for output is at an annual rate of \$500 billion might apply to "right now"; the rate may have changed by tonight.

To relate the stock of money to the rate of money flow, we must introduce some concept of the average "velocity" or "rapidity of turnover" of the money stock. An important characteristic of money is that it has some durability and can be used over and over again. We may not use again that dollar we spent last night but someone

else can use it. The flow of money expenditures varies with the size of the stock of money and its average velocity or rapidity of turnover. For example, if the money supply is \$150 billion and if on the average each dollar of it is spent for output four times a year, the flow of expenditures for output will be at an annual rate of \$600 billion. The same stock of money with each dollar of it spent for output on an average of only three times a year would produce a rate of expenditure for output of only \$450 billion a year. Since the velocity of money is not constant, we cannot assume that the supply of money and the flow of money expenditures will always move proportionally.

It is the flow of money expenditures rather than the money supply that is most directly relevant to the behavior of output, employment, and prices in an economy. In determining their policies relative to output, hiring, and prices, producers and sellers are most interested in the current and prospective flow of money demand for their goods and services. They have no such direct concern for the size of the money stock. Nevertheless, we shall for two reasons begin with a long section on the money supply : (1) The size of the stock of money is a major determinant of money flows. (2) Under the conventions of our society the stock of money is subject to more direct official control than is its velocity.

The rapidity of turnover of money is decided by people's decisions as to holding versus spending their money receipts and as to how long they will hold money before spending it. Direct government control of these individual decisions is not considered acceptable. But it is generally conceded that governments should regulate, if not control with precision, the supply of money. From a public policy point of view it is sometimes useful to concentrate attention on those factors in a situation that are subject to control. Moreover, we shall see that it may be possible to regulate the money supply in such a way as to offset, at least in part, fluctuations emanating from changes in the velocity of money.

The definition of "money" and the things included in the money supply vary from place to place and from period to period. The crucial test is this: Is the thing generally used as a means of payment?

Is it generally acceptable in exchange for goods and services? Anything that meets this test is money for that area and that period.

Examples of Money :

Anyone who begins his study of money with the belief that there is some one thing that “is by nature money” and that has been used as money at all times and in all places will find monetary history very disconcerting, for a most heterogeneous array of things has served as circulating media. An incomplete list of these is given in Table 1.

Some of these are animal, some vegetable, some mineral; some, such as debts, defy this classification. Some are as valuable for non-monetary purposes as they are in their use as money; others are practically worthless for purposes other than money; still others are valuable for non-monetary purposes, but not as valuable as in their monetary use. Some are quite durable, whereas others are much less so. About the only characteristic that all these articles have in common is the fact that each of them was able, at some time and place, to achieve general acceptability as a means of payment. And the reasons for their general acceptability certainly varied from place to place and from time to time.

Table 1. An Incomplete List of Things That Have Served as Money

clay	goats	hoes	iron
cowry shells	slaves	pots	bronze
wampum	rice	boats	nickel
tortoise shells	tea	porcelain	paper
porpoise teeth	tobacco	stone	leather
whale teeth	pitch	iron	pasteboard
boar tusks	wool	copper	playing cards
woodpecker scalps	salt	brass	
cattle	corn	silver	debts of individuals
pigs	wine	gold	debts of banks
horses	beer	electron	debts of governments
sheep	knives	lead	

The very heterogeneity, in the forms of the various things that have served as money suggests, that there is no one form of money that is best at all times, in all places, and under all physical and cultural conditions. Gold and silver may have served England well in the seventeenth century, but the Indians of the New World spurned them and used wampum. A native of Malaita would no more think of accepting a checking deposit as money than a New York broker would think of accepting porpoise teeth. What will serve best as money depends upon many things, such as the stage of economic development, the availability of the various things that may be used as money, the people's taste in ornaments, the nature of religious practices, the extent of literacy, the stage of development of financial institutions, the honesty and strength of the government, and past monetary experiences.

Types of Money :

Though the monetary systems of advanced countries show wide variations, their circulating media have been mainly of the following types: (1) checking deposits, (2) paper money issued by governments, central banks, and privately owned banks, and (3) coins of various kinds. These are listed in the order of their present importance as means of payments. Most of our payments are made by transferring claims on banks from payers to payees, the bank debts being transferred by check. Next in importance as an exchange medium

Table 2. Classifications of Money

- I. Full-bodied money
- II. Representative full-bodied money
- III. Credit money
 - A. Issued by government
 1. Token coins
 2. Representative token money
 3. Circulating promissory notes
 - B. Issued by banks
 1. Circulating promissory notes issued by central banks
 2. Circulating promissory notes issued by other banks
 3. Demand deposits subject to check

is paper money, which is usually a debt of a government, a central bank, or a privately owned bank. Coin is the least important of all; it is, in effect, the small change of the economic system. We must emphasize that our circulating medium is made up largely of debts (or credits) which are transferred from payers to payees.

A classification of modern money that is more useful for analytical purposes is given in Table 2. It is based on the relationship between the value of money as money and the value of money as a goods for non-monetary uses.

Full-Bodied Money : Full-bodied money is money whose value as a goods for non-monetary purposes is as great as its value as money. It is versatile money; it can desert its monetary job and take up other occupations without losing value, if too much of it does not leave monetary uses. There have been many examples of this type of money. Most of the early goods moneys—such as cattle, rice, wool, and boats—were as valuable for non-monetary purposes as they were in their monetary use. The principal full-bodied moneys in modern monetary systems have been coins of the standard metal that are issued when a country is on a metallic standard: a gold standard, a silver standard, or a bimetallic standard using gold and silver.

Full-bodied coins usually result when following two conditions exist: (1) Money can be shifted from monetary to non-monetary uses virtually without cost, and (2) the metal can be coined into money without limit and virtually without charge. The ability to shift coins from their monetary use without cost prevents their being worth more as a commodity than as money. Any tendency for the market price of the commodity in the coin to rise above its face value—its price as a coin—would lead to a melting down of coins and the sale of their contents as a commodity. This would continue to the extent necessary to hold the market price of the commodity down to the face value of the coin or until all such coins had been drained from the monetary system. Even the threat of death has usually proved incapable of preventing the melting down of coins when this was profitable.

On the other hand, when a metal may be coined into money without limit and virtually without charge it is impossible for the coins to have a higher value as money than as a material for other uses. Any tendency for the market price of the metal to fall below the face value of the coins into which it could be minted would be corrected by a diversion of the metal from the market to the mint. For example, for many years before 1933, the federal government stood ready to coin gold in unlimited amounts and with only a negligible charge; it gave a dollar for each 23.22 grains of fine (pure) gold offered to it. This amounted to setting a purchase price of \$20.67 per ounce of fine gold, because an ounce of gold (480 grains) will yield 20.67 dollars of 23.22 grains each. The minimum price of gold in the market became \$20.67 per ounce, because as long as the government stood ready to buy all the gold offered at this price no one would sell for less, no matter whether the gold was to be coined or used in dentistry.

In summary, the equality of the monetary and non-monetary values of full-bodied money is usually maintained by these two flows. The option of converting the money freely into a goods for non-monetary use prevents the market price of the material in the coin from rising above its face value as long as coins are available for this purpose. No one would pay more than \$20.67 an ounce for gold in the open market as long as he could melt down full-bodied gold coins. And the option of converting the material into money without limit and virtually without expense prevents the market price of the material from falling below the face value of the coins into which it could be converted.

Full-bodied money has in the past played an important role in the monetary system of the United States as well as in the systems of other countries. All coins issued by the federal government in the first few decades after the establishments of the mint were full bodied, and full-bodied gold coins were in circulation, though in decreasing quantities, until 1933. In that year, however, all gold was called in by the government and the coinage of gold was discontinued. No full-bodied money has circulated in the United States since 1933, and this type of money has for many years been a rarity in most other countries.

Despite the fact that full-bodied money has all but disappeared from modern monetary systems, many persons still feel that it is superior to the “flimsier” types of money. They believe that it is “safer” because of its ability to shift without loss of value to non-monetary uses, such as jewelry, dentistry, gold plate, gold leaf, and so on. Most of these persons seem to think that the value of a full-bodied coin merely reflects the value of the material in it for industrial and artistic purposes, and that the value of the metal is determined solely by its supply and by its *demand for non-monetary uses*. This is clearly an erroneous idea. The value of any metal, both for industrial purposes and as a full-bodied coin, depends on its supply and on the aggregate demand for it, and the aggregate demand is made up of following two parts:

(1) the demand for it for use as money, and (2) the demand for it in other uses, such as industry and art. As soon as a metal comes to be used as money, the monetary demand for it may easily become the larger part of the total demand, and the value of the metal may depend largely on the behavior of the monetary demand for it. This is especially true of gold. How much purchasing power would gold have if no important country would purchase any of the current output for monetary use, so that the only remaining demand was for non-monetary purposes? What would be the value of gold if all countries demonetized it and threw on the industrial market the hundreds of millions of ounces that they now hold in their monetary gold stocks? The value of gold would surely decline as the monetary demand for it disappeared. This is particularly likely in view of the fact that the non-monetary demand for gold is to such a large extent derived from its use for “conspicuous waste”—in jewelry, gold plate, and gold leaf. If gold lost its monetary use and depreciated seriously, people might well turn to other means of ostentation.

We are thus led to following two important conclusions : The first is that though the value of a full-bodied coin as money is equal to its value as a commodity for non-monetary uses, the value as money does not merely reflect a value determined by the supply and the non-monetary demand. Instead, the value of the metal both as money and for other uses depends on the supply and on the

aggregate demand for monetary and non-monetary uses, and the monetary demand is often dominant. The second conclusion is that though small amounts of full-bodied money may be able to shift to non-monetary uses without loss of value, this is not possible on any large scale. Mass attempts to convert full-bodied coins into bullion for other uses are likely to reduce the value of the metal.

This fact is clearly brought out by the history of silver. Before the last quarter of the nineteenth century, many important countries stood ready to coin all the silver offered to them at a value equal to around $1/15$ or $1/16$ of the value of gold; hence the value of silver for both monetary and non-monetary uses was fixed at that level. But after these countries had withdrawn from silver the privilege of unlimited coinage, thereby decreasing its demand, for monetary purposes, its value fell precipitately. In the 1920's its value averaged only about $1/30$ of the value of gold. In the late 1950's its value was only about $1/38$ of the value of gold. There is no reason to believe that the value of gold would escape at least as great a decline if its monetary use were similarly curtailed.

Some persons favor the exclusive use of full-bodied money because of its automatic limitation upon the quantity of money that can be created. Fearing that irresponsible monetary authorities would resort to inflation if token coins, paper money, or other debts were used as money, they would define the monetary unit in terms of a metal and then limit the money supply to the amount of the metal or metals offered for coinage. Though this technique might prevent the most extreme inflation's, it would not at all assure an appropriate behavior of the money supply or of the flow of money spendings. For example, new gold strikes or a decreased use of gold in industry and the arts could swell the money supply far beyond the amounts needed to carry on trade at stable prices, and the failure of gold production to rise sufficiently during periods of rapidly advancing production and trade could bring about a deficiency of money spendings, then falling prices and unemployment.

Another shortcoming of full-bodied money is its cost. To get the gold, silver, or other metal needed for full-bodied money, a nation must devote part of its productive power to mining and refining, or

it must exchange part of its output of other goods and services for the metal of other nations. Credit money can be obtained more cheaply. Full-bodied money would probably be worth the extra cost, however, if in fact it performed monetary functions more satisfactorily than other types of money.

Representative Full-Bodied Money : Representative full-bodied money, which is usually made of paper, is in effect a circulating warehouse receipt for full-bodied coins or their equivalent in bullion. The representative full-bodied money itself has no significant value as a commodity, but it "represents" in circulation an amount of metal with a commodity value equal to the value of the money. Thus, the "gold certificates" that circulated in the United States before their recall from circulation in 1933 represented fully equivalent amounts of gold coin or gold bullion held by the Treasury as "backing" for them.

In some respects, representative full-bodied money is similar to full-bodied money. The amount of it that can be issued depends upon the quantity of full-bodied money or its bullion equivalent available as "backing," and the cost of the "backing" material is as great as that of full-bodied money. This type of money has certain advantages over full-bodied money. In the first place, its use obviates the expense of coining, though against this must be set the cost of providing and maintaining the pieces of representative paper. In the second place, it avoids ordinary abrasion as well as the deliberate sweating, clipping, and chipping to which circulating coins are sometimes subjected. In the third place, it is easier to transport than the full-bodied money that it represents. This was certainly true of the Swedish representative money that circulated in place of massive copper coins during the seventeenth and eighteenth centuries, of the warehouse receipts for tobacco that circulated in Virginia and some of the other colonies, and of the pre-1933 gold certificates. The principal disadvantages of this type of money as compared with full-bodied money are the ease of counterfeiting it if the representative paper money is not very distinctive, and its destructibility by fire.

Credit Money : All the money in circulation in the United States and almost all the circulating moneys in other countries are credit

money. By credit money we mean any money, except representative full-bodied money, that circulates at a value greater than the commodity value of the material of which it is made. The principal modern types of credit money are token coins, paper money, and checking deposits. Each of these will be discussed in turn.

Token Coins : All of the circulating coins in the United States—silver dollars, half dollars, quarters, dimes, nickels, and pennies—are token money; their value as money is significantly greater than their value as materials in the commodity market. The market values of the materials in these coins are shown in Table 3. Silver would have an even lower value as bullion if it had been completely deprived of its monetary use so that the only demand for it was for other purposes.

Why are people willing to accept these coins in payment at values far above the values of the materials out of which they are made? The fundamental reason is that the quantity of these coins is deliberately limited by the government. We saw that the value of full-bodied money cannot rise above the value of the materials of which it is made because of unlimited coinage at virtually no cost to

Table 3. Metallic Content and Commodity Values of United States Coins

Coin	Total Weight in Grains	Composition	Market Value of
			Commodity Content of Coins at June, 1958, Prices (in Cents)
Dollar	412.5	90% silver, 10% copper	67.2
Half dollar	192.9	„	31.9
Quarter	96.45	„	16.0
Dime	38.58	„	6.4
Nickel	77.16	75% copper, 25% nickel	0.4
Penny	48.00	95% copper, 5% tin, and zinc	0.2

the suppliers of metal. But the government does not permit free and unlimited coinage in the case of token coins. Instead, it purchases the required metals at its own option and itself determines the quantities of token coins that it will issue. By appropriate limitations on the supply of these coins it can maintain their monetary value well above their commodity value. It can also make a profit equal to the difference between the cost of the material in the market and the value of the coins made from it. For example, it can pay \$90.50 for 100 ounces of silver in the market and coin it into \$129, thereby making a \$38.50 gross profit. These profits are usually called *seignior age*.

To insure that token coins will remain at parity with other types of money, the monetary authorities often provide for the free exchange of token coins for other types of money on a dollar-for-dollar basis as well as for the free exchange of other types of money for token coins. They then limit their issues of token coins to the amounts that people want to use or hold on a parity basis. But though this free interchangeability of the various types of money is usually necessary to maintain these various types at strict parity with each other, it must be emphasized that the basic reason why token coins can circulate at a monetary value above the value of the materials of which they are made is the limitation on their issue.

The above arrangement under which the government issues token coins made of metal purchased at its own option and in quantities determined by itself is the one ordinarily used today. But there have also been token money systems in which governments coined all the metal offered to them, but only at a very high cost to the suppliers of it, the governments retaining the high margin as *seignior age*. For example, suppose that the monetary unit of a country is the *dinar* and that a 1-*dinar* piece contains 100 grains of silver. The government might stand ready to coin all the silver offered to it, but to give only 1 *dinar* for each 200 grains of silver. The market price of silver could fall as low as 1 *dinar* for 200 grains of silver, the government purchase price. The 100 grains of silver in the *dinar* could be worth as little as half a *dinar* in the commodity market. This underlines the fact that unlimited coinage or purchase

of a metal is not sufficient to make a coin full bodied; the coinage must also be virtually without cost to the supplier of the metal. The market value of the material in a coin can fall below the monetary value of the coin by the amount of any charge made for coinage.

Representative Token Money : Representative token money, which is usually paper, is in effect a circulating warehouse receipt for token coins or for an equal weight of bullion that has been deposited with the government. It is like representative full-bodied money, except that the coin or bullion held as "backing" is worth less as a commodity than as money. Silver certificates are the only example of this type of money in the United States. These have been in circulation in varying amounts since 1878 and are "backed" by an equivalent number of silver dollars or by silver bullion of equivalent weight. Most of our \$1 bills are silver certificates, as are some of our \$2, \$5, and \$10 bills. Most economists see no advantage in having a paper money "backed" by silver with a commodity value far below its monetary value. They believe that the money function could be served fully as well by an equivalent amount of paper currency without specific backing. But silver producers, constantly on the alert for better markets for their product, take a different view.

Circulating Promissory Notes Issued by Governments: Governments also issue credit money in a form that is usually, but sometimes inaccurately, called circulating promissory notes. These are usually made of paper and are sometimes called *fiat money*. Some of them carry the government's promise to redeem them in other types of money on demand; this is why this type of money is usually called circulating promissory notes. Others, however, lack this promise and in effect say, "This is a certain number of monetary units."

The only circulating promissory notes issued by the United States government and still in circulation are the United States notes, or "greenbacks," which were issued to assist in financing the Civil War. Over \$400 million of them were originally issued, but they were reduced to \$347 million by 1878 and have since remained at approximately that level.

Many people oppose the use of government paper money, fearing that it will be issued in excessive amounts. Monetary history provides a real basis for this fear, because these issues provide an attractive source of revenue to governments. By spending a small amount for paper, engraving, and printing, a government can produce millions of dollars' worth of paper money, which can then be used to pay its debts or cover its expenses. The temptation to sacrifice proper monetary management to budgetary needs is often strong. It should be pointed out, however, that most of the excessive issues of paper money have occurred during war periods when nations felt that their very existence was at stake and when they were in dire need of more money to meet military requirements. There is no reason why a properly managed government paper money should not function well.

Circulating Promissory Notes Issued by Central Banks : A considerable part of the hand-to-hand currency that is used in most advanced countries is in the form of circulating promissory notes issued by central banks, such as our Federal Reserve banks, the Bank of England, and the Bank of France. The largest part of our paper money is made up of Federal Reserve notes, which are circulating evidences of debt issued by the twelve Federal Reserve banks. In some cases the paper money issued by central banks is redeemable in other types of money; in other cases it is irredeemable. Though the Federal Reserve banks will redeem their notes in token coins or other types of paper money, they are not obligated to redeem them in full-bodied money.

Circulating Promissory Notes Issued by Private Banks : Circulating promissory notes that are issued by privately owned banks have played an important role in monetary systems. Promissory notes issued by state-chartered banks and by the First and Second Banks of the United States provided a large part of the circulating medium in this country before the Civil War, and the national banks chartered by the federal government issued such notes from the Civil War until 1935, when their power of note issue was rescinded. Though most of the notes issued by privately owned banks have been retired in this country, they are still used extensively in some other areas. These notes, it must be emphasized,

are only circulating evidences of bank debts—creditor claims against banks.

Checking Deposits at Banks: The major part of the money supply in our country, as well as that in most other advanced countries, is in the form of demand deposits at banks. These so-called “deposits” are merely bank debts payable on demand: claims of creditors against a bank that can be transferred from one person or firm to another by means of checks or other orders to pay. These claims against banks are generally acceptable in payment of debts and for goods and services. They are used almost exclusively in transactions involving large payments and very widely in small payments, such as those from customers to retailers and salaries and wages to employees.

The popularity of checking deposits can be traced to their advantages: (1) They are not so liable to loss or theft as other types of money. (2) They can be transported very cheaply, no matter how large the amount of the payment or how great the distance from payer to payee. (3) Checks can be written for the exact amount of the payment, thereby obviating the necessity of making change and counting bills and coins. (4) When endorsed by the payee, checks serve as a convenient receipt for payment. The principal disadvantage of checking deposits is that checks drawn on them may not be accepted from an unknown person, but this is largely remedied by such devices as certified checks, cashier’s checks, and traveler’s checks.

General Acceptability of Money :

Though many countries, including the United States, have long used credit money and this credit money has often not been redeemable in gold, silver, or any other money with a substantial non-monetary value, the feeling still persists in some quarters that pieces of money cannot be “good” or even generally acceptable unless they themselves have an equivalent value for non-monetary purposes or are kept redeemable in other types of money that have an equivalent value for non-monetary uses. At the risk of excessive repetition we must point out again that this view is erroneous. That

token coins, paper money, and other circulating debts can be over issued, and on too many occasions have been, is undeniable. But if their issue is properly limited they can be given a scarcity value and can circulate at least as satisfactorily as any full-bodied money; in fact, with proper management their quantities can be adjusted to the needs of trade better than can the quantities of a gold or silver full-bodied money whose supply often reflects the capriciousness of gold or silver mining.

Money can have a value simply because it is limited in supply and is demanded for use as money. Barter, as we have seen, is inconvenient. To escape these inconveniences, people want some kind of "tokens" or "tickets" that can be used as means of payment. In determining whether or not to accept such tickets in payment of debt or for goods and services, each person is interested in only one question: "Can I pass them along to someone else in exchange and without loss of value for the things I want to buy?" He is interested in their acceptability as money, not in their usability for some other purpose.

Such things could come into general monetary use in a group that had no previous monetary experience. Let us imagine, for example, the Zanzabu tribe, whose chief is Fungo II. The members of the tribe have been trading among themselves, but only by means of crude barter. By democratic processes or by edict of the chief they establish a monetary system, using the pecunio as their monetary unit. The physical things used as money may be baked pieces of clay bearing the seal or other distinguishing mark of Fungo II and the notation "1 pecunio," "5 pecunios," or "10 pecunios." To assure limitation of "coinage" and to prevent the chief from converting the system to his own uses, a committee of elder statesmen may be appointed to supervise the "mint." Though they have no use for other purposes, these imprinted pieces of clay may be readily accepted in trade by the tribal members who are happy to escape the clumsiness of barter. The acceptability of pecunios may be expedited somewhat by an edict declaring them to be acceptable in payment of taxes, or declaring them to be legal tender in payment of debts, or giving them both powers. No trouble need arise if the tokens are issued in proper amounts.

After a while, however, Fungo II or the tradesmen may decide that the monetary system is inefficient; some of the able-bodied members of the tribe must spend their time imprinting and baking the pieces of clay, and the tokens are liable to theft and are heavy to transport in quantities. They may therefore decide that they will supplement the "coin" system with book credits. The tribal treasurer, or perhaps a reputable tradesman, will set up pecunio credits on his books, and these credits can be transferred by written order from one tribesman to another in payment. At first the tribesmen who receive claims against the treasurer or tradesman may demand that they be redeemed in "coin." Later, however, after they have become accustomed to the system, they may make virtually all their payments by transferring book credits from payers to payees. The volume of pecunio credits or debts available for transfer in making payments may become far greater than the volume of "coins" in existence. In fact, the "coins" may be discontinued entirely.

Though modern credit money systems could have arisen in the manner indicated above, they are actually the result of a long evolution that is still in process. "The longer history of money has shown an almost unbroken evolution from commonplace, concrete, and simple forms to the representative, incorporeal and abstract." The general nature of this evolution was somewhat as follows. Let us start with the use of un-coined metals, such as copper, gold, and silver, as circulating media. These metals probably came to be widely acceptable in payment because they were widely desired for ornamental and religious purposes, they did not deteriorate, they were relatively easy to transport, and so on. At this stage money was not differentiated at all from the material of which it was made; the metal flowed freely into and out of monetary uses.

The use of bullion as money had serious disadvantages, however. Precision weighing apparatus was not widely available and assaying was both laborious and inaccurate. Coinage solved, at least in part, both of these problems. At first, coinage amounted merely to an official certification as to the purity and weight of the lump of metal. The imprint of the king's stamp meant in effect, "I hereby certify that this contains a certain weight of metal of a certain purity." The names of many monetary units—pounds, livers, lire,

and shekels—which were originally units of weight attest to this fact.

Coinage was an important monetary innovation. It greatly expanded the use of metallic substances as money. More important, however, it was a long step toward the differentiation of money from its component material. Not metal but *coined metal* became money. People gradually ceased to think in terms of the *weights* of metal; they thought in terms of the *number* of coins—not the weight of silver in a payment, but the number of shekels or lire. Debts and other contracts came to be stated in monetary units. This habit often persisted after the pure metallic content of the coins was reduced through abrasion, clipping, chipping, sweating, or deliberate action of the sovereign. When coinage was limited, the value of the coins as money often rose above the commodity value of their reduced metallic content; token coins appeared. Token coins also came into circulation at times as tokens redeemable in full-bodied money. After the group had become accustomed to these tokens, they continued to be acceptable whether or not they were redeemable in other money.

The use of representative paper money probably arose out of governments' desires to save the costs of coinage and of keeping coins in good condition as well as from the greater ease of transporting pieces of paper. The pieces of paper may have been acceptable at first, largely because of confidence that they were fully "backed" and that they would be redeemed in full-bodied money on demand. But after attaining general acceptability they could retain their monetary use even though the right of redeemability was withdrawn. The same is true of circulating promissory notes, whether issued by a government or by a reputable bank or merchant. At first their acceptability probably rested largely on confidence that the issuer would pay them on demand in other types of money. Then they continued to circulate after the promise to pay other types of money was rescinded and the pieces of paper bore only the legend "This is X dollars." We shall see later that the use of checking deposits evolved in this same general way. At first people may have been willing to accept and hold claims against banks only because they believed that their claims were fully "backed" by full-bodied

money. But after the practice of accepting and holding claims against banks became solidly established, people continued to be willing to accept and hold these claims even though they knew perfectly well that the banks held only very small amounts of coin and paper money and that the "deposits" were nothing but bank debts.

At the present stage of monetary evolution there can be no doubt that people in the principal nations of the world are fully accustomed to the use of credit money and that by far the larger part of their payments is made by the transfer of bank deposits and paper money. Coins are typically the "small change" of economic systems, and full-bodied money has all but disappeared from general circulation.

Money Supply of the United States :

We shall define the money supply of the United States at any time as the total of coin, currency, and demand (checking) deposits owned by the American "public," that is, by all individuals, business firms, and state and local governments. Table 4 shows the composition of the money supply of the United States. A study of this table brings out several important facts about our monetary system.

1. There is no full-bodied money in circulation, and the \$33 million of representative full-bodied money (gold certificates) listed in the table have been lost, destroyed, or locked up in private hoards, for they may not legally circulate. The entire money supply is in the form of credit money. Or, since credit is merely debt looked at from the reverse side, all the money is debt money; it is in the form of a liability or debt of the issuer. This is clearly true of demand deposits; they are merely debts or liabilities of the commercial banks. Likewise, Federal Reserve notes are merely debts or liabilities of the twelve Federal Reserve banks, and the various types of Treasury paper money are but debts or liabilities of the Treasury. The token coins, which are stamped pieces of metal instead of stamped pieces of paper, are also debts or liabilities of the Treasury.
2. Ranked in order of size, the types of money are: checking deposits, paper money, and coins. Checking deposits make

up more than three-quarters of the money supply, and it is estimated that they are used to effect more than 90 percent of all money payments. Paper money represents about 22 percent of the total, and coins are indeed the “small change” of the system, constituting only 1.5 percent of the total. It should be noted that this distribution represents the choice of the holders, for the banks and the Treasury stand ready to exchange the various types of money for each other on a dollar-for-dollar basis.

3. Ranked in order of size of their outstanding money issuers the issuers of money are: the commercial banks, the Federal Reserve banks, and the Treasury. The 13,500 commercial banks, which are privately owned and privately operated institutions, are the issuers and are liable for the type of debt that we call demand deposits, which makes up more than three quarters of the money supply. The Federal Reserve banks are the issuers and are liable for the debts called Federal Reserve notes, which *make* up about a fifth of the money supply.

Table 4. Kinds of Money in Circulation in the United States, (In millions of dollars)

	Amount	Percent of Total
Full-bodied money	\$ none	0.0
Representative full-bodied money (gold certificates)	33	—
Credit money issued by the Treasury		
Token coins	2,076	1.5
Representative token money (silver certificates)	2,119	1.5
Circulating promissory notes	495	0.4
Credit money issued by Federal Reserve banks		
Circulating promissory notes (Federal Reserve notes)	25,845	18.8
Credit money issued by commercial banks		
Demand deposits subject to check	107,200	77.8
Total money supply	\$137,768	100.0

The Treasury itself issues less than 4 percent of the money in actual circulation. Thus, the Federal Reserve and commercial banks together supply us with more than 96 percent of our actual circulating medium. This fact alone explains why it is impossible to discuss money and banking separately.

4. All types of circulating money in this country, except checking deposits, have full legal-tender powers. That is, they have the legal power to discharge debts; creditors may not insist on payment in any other type of money if the debt is stated in dollars. Though checking deposits are not themselves legal tender, the banks are obligated to redeem them on demand in legal-tender money. This lack of legal-tender power reduces the general acceptability of demand deposits only in periods when people doubt the banks' ability to redeem their debts.

Near Money :

It is now necessary to raise some questions concerning our definition of money, which includes all coins, paper money, and checking deposits owned by American individuals, business firms, and state and local governments. There is little doubt that all these things should be included in the money category. They are all perfectly "liquid"—that is, they remain at par in terms of the monetary unit at all times—and they are in fact generally acceptable at face value in payment of debts and for the purchase of goods and services. However, some economists believe that this definition is perhaps too narrow and that it excludes some other assets that have a high degree of "moneyness" and that at least to some extent perform monetary functions. They also believe that the rate of spending by the public is affected by their holdings of these other highly liquid assets almost to the same extent as by their holdings of money as we have defined it.

Time and savings deposits at commercial, mutual savings, and postal savings banks are in fact highly liquid. These are debts of the issuing institutions, which usually are not legally payable on demand, as are checking deposits, but are legally payable only after the passage of a specified period of time. In practice, however, the banks in many cases waive this requirement and permit withdrawals on demand. In fact, therefore, these deposits are often almost perfectly liquid and have the attributes of money in serving as a store of value, with the added attraction that they usually bear interest. To a very limited extent they are even transferred by checks or other orders from payer to payee as a means of payment. This,

however, is rather uncommon; in most cases one who wishes to surrender his time or savings deposit to make payments to others must first surrender it in exchange for some form of money as we have defined it, and then use this money to pay his bills.

There are other types of assets that remain so stable in terms of money that they may be considered to be "near-moneys." Short-term government securities (and sometimes even long-term securities) are cases in point. To the extent that their values are constant in terms of money, they have the qualities of money as a store of value and can be converted into money for spending purposes without loss. But they are not themselves commonly used as a means of payment.

It is worth remembering that many types of assets have the quality of money in varying degrees. Nevertheless, we shall for many reasons stand by our earlier definition of money. (1) Only coins, paper money, and checking deposits are in fact generally used as means of payments. The other liquid assets, even those whose value in terms of money remains fixed, can ordinarily be employed as a means of payment only by being first converted into money as we have defined it. (2) From the point of view of monetary policy, it may at times be desirable to make more expensive the step of converting these other assets into money proper. For example, it may be desirable to force people to take losses if they try to convert government securities into money. (3) The rate of spending depends not only on the supply of money and other liquid assets, but also on many other things, such as the people's total wealth, both liquid and illiquid, and their expectations as to future incomes and price levels. To include these other liquid assets in the money supply simply because they exert an influence on the rate of spending would raise questions as to why other determinants of the spending rate were not also included. (4) Since all assets possess the quality of money in varying degrees, any other definition would leave equally troublesome borderline cases.

For all these reasons we shall retain the earlier definition of money, though it will be well to remember that the dividing line between money and non-money is somewhat arbitrarily drawn.



CHAPTER



FAILURE OF MONETARISM

India succeeded by a steady and cautious policy of economic expansion, inspite of the difficulties caused by rapid population growth, to make remarkable and steady progress both in agriculture and in industry and she has resisted the temptations offered by international private lenders on attractive-looking terms which have landed the countries which came to depend on them in the most acute difficulties when all of a sudden interest rates soared to unprecedented levels in consequence of the new economic policies pursued by the U.S.A.

As a result of these events a number of countries have been unable of meet existing financial commitments without further borrowing and there by got into fearful difficulties. These cautious and sober policies kept India out of trouble when most of the countries of Latin America, and a large number of others were forced, by financial pressure exercised through a consortium of bankers or through the International Monetary Fund, to contract their economies, causing a sudden halt to the process of investment and enforcing a reduction in the standard of living of their working populations.

This lesson will mainly be devoted to an analysis of how this situation came about as a result of the triumph of foolish ideas in

America and also, though this is far less important in a world context, in Britain. The British Raj-whatever one may think of it in other respects- was a remarkable administrative construction. It made the Indian sub-continent into a single country, tied together by uniform laws and uniform rules and standards of administration, whilst preserving the variety of local customs and languages- held together by an administrative superstructure, which proved strong enough and resilient enough to preserve India as an entity (apart from the single though very important exception of Pakistan) after the unifying force of the foreign occupying power was removed. India became independent with a federal constitution run by a multitude of freely elected assemblies but with an overriding national consciousness.

It is to Britain's credit of having done so much to create modern India by preparing the country for independence- through the establishment of a network of higher educational institutions for the infusion of western science and technology; and through a system of selection for the higher grade administrative posts by competitive examinations which enabled a steadily rising proportion of such posts to be filled by Indians with a Western education-an education acquired partly in India and partly in England.

How the discarded and discredited ideas of 60 years ago became the official policies of the most important central bank of the world, the Federal Reserve System of the United States. Fortunately the American Constitution, based on the principles of Montesquieu; gives for the division of powers which ensures at present that while monetary policy conducted by the Federal Reserve and the United States Treasury pulls in one direction, taxation and fiscal policy, as determined by Acts of Congress, pulls in the opposite direction. Hence, in contrast to the pre-war situation when the contraction of the US economy created the world dollar shortage, and was the main cause of world-wide deflation, there is no world dollar shortage at present; the United States balance of payments on current account is in the red to the tune of over \$ 30 billions which is expected to reach \$ 60 or 70 billions. Together with the disappearance of the petrodollar surplus of the OPEC countries this will greatly ease, if

not altogether remove, the balance of payments constraint on the economies of the rest of the world- though given the foolishness of many political leaders of the West, there is no telling what might happen.

The biological process of natural selection should make for the development of favourable traits in the human character-and that includes the acceptance of ideas and beliefs that promote progress and the rejection of ideas that have the opposite effect. As we all know this is not, unfortunately, either a smooth or a continuous process-it proceeds by fits and starts. The religion of most societies contains the basic dualism between good and evil spirits, between angels and devils, between the purveyors of good advice and the purveyors of bad advice. The choice between them is often represented as a moral issue whereas it is more truly a matter of flair and intuition which some times works and sometimes does not. Decadence, according to Nietzsche, is a state in which the individual intuitively goes for the bad solutions for getting out of difficult situations, and fails to pick out the good ones.

The alarming thing is not that some people should hold crackpot ideas-the alarming thing is when crackpot ideas sweep the board-when they capture the minds of a wide selection of important and influential people. This has been the case with the rapid spread of monetarism among academics, journalists, bankers and politicians in the ten years following the first "oil shock" in 1973. Ultimately the devil fails- at least this has been the case hitherto, otherwise we should not be here. But the cost is sometimes broadness-whether through wars, revolutions or the misery and agony inflicted by mass unemployment, loss of opportunities, loss of skills or even loss of knowledge and know-how.

Function of Central Bank :

The term "monetarism" does not mean "monetary policy", as ordinarily understood. The latter term relates to the policy or policies conducted by the central bank. Monetary policy can be of numerous kinds. It could be Keynesian or orthodox, it could also be "monetarist" in the special sense used here, except, as I shall attempt

to show, the latter is not likely to be a viable policy in terms of its own objectives. However, as Adam Smith has shown in the *Wealth of Nations*, banks form a most important institution for economic development, since it is the availability of bank credit which alone makes possible the exploitation of new investment opportunities as they accrue and before the savings generated by the exploitation of enlarged economic potential come into existence. It is the primary function of the central bank to ensure that the expansion of bank credit from being clogged up through excessive credit creation. The art of central banking, as Hawtrey explains, was to make sure that the right amount of new credit is generated, neither more nor less.

The rise of the new monetarism is mainly associated with the work of a single pioneer, Milton Friedman, a man of unusual ingenuity and powers of persuasion, but also an impish character of whom one can never be sure whether he is serious or just kidding-how far he just enjoys the spectacle of parrying the intellectual blows of his opponents by a rich variety of counter-thrusts in unexpected directions-so that he need never acknowledge defeat. The charge of intellectual dishonesty is a serious one and should not be made lightly. However, in connection with Friedman's empirical investigations it has been made more than once, recently and most effectively in a paper by Professor D.F. Hendry (who is professor of econometrics at Oxford) and published by the Bank of England.

Friedman's work as an economist can be mainly characterised as a counter-reformation-the reaction against the new economics of the 1930s and the return to 19th century orthodoxies. This involved both a denial of the theories of imperfect competition which were destructive of the neoclassical macro economics which replaced the orthodox ideas on money and inflation.

Three Assumptions :

More specifically modern monetarism is characterised by three particular assumptions- all of which are part of the credo of the (original) Chicago School. These are :

- (1) Prices in all markets are completely flexible-they rise in response to excess demand and fall in response to excess

supply. Since prices in a perfect market must settle at the point where and demand are equal, neither commodities nor services can be in a state of "excess supply" more than momentarily. (This comes to the same as the assumption that a market economy, left to itself, is self regulating- it functions so as to ensure the full and efficient distribution of resources).

- (2) There are no important differences between a (pure) commodity money economy (where money consists of gold or silver or oxen) and a credit-money economy where money consists of negotiable debt certificates-promises to pay of financial intermediaries which are convertible only in the sense that they can be exchanged into other forms of debt. (A bank cheque can be converted into bank notes: a bank note into other bank notes and so on).
- (3) Effective control over the "money supply" will have a direct influence on the level of demand, and hence of prices: successful control of the money supply is both a necessary and a sufficient condition for moderating the rate of inflation-and indeed bringing it to an end, if the control is maintained long enough.

All three of above propositions are based on false premises and are the main sources of error in monetarist thinking.

- (1) The first assumption leads to a failure to recognize the all important difference between a demand inflation and a cost-inflation. In the 'Walrasian' model of the economy, which is at the bottom of all Friedmanite thinking, a rise in prices can occur only as a result of excess demand in some or all the markets. Costs (or incomes generated in the process of production) in that model of the economy are derived from prices, hence they cannot exert an autonomous influence on prices. In the real world however, except in special circumstances where there is an excessive pressure on resources (this generally happens as a result of a major war and its aftermath, but it can also happen as a result of

failure of a government to cover an adequate proportion of its expenditure by normal revenues), prices of goods and services rise in consequence of a rise in costs- whether material, fuel, or labour costs- and such cost induced rise in prices tends to generate further prices and cost increases even in circumstances in which there is an excess supply both of labour and of productive capacity.

Thus, the strict monetarist view denies that trade unions can bring about a rise in the prices of commodities. They may have the power to raise wages, but in the absence of an expansion of the money supply this cannot cause any rise in the prices of the goods which they produce. (This was Mrs. Thatcher's view in the first year of office when she frequently said that all labour can do is to price itself out of the market-it cannot cause inflation. In her second year however she changed her position and admitted that a reduction of price-inflation pre-supposes a reduction in the size of wage settlements).

- (2) The second assumption carries the implication that money has an 'exogenous' supply schedule in a credit money economy, which determines the quantity available independently of the demand for it-it denies the basic difference in casual relationships between a commodity money system and a credit-money system.
- (3) The third assumption implies that the quantity of money and the velocity of circulation are mutually invariant, whereas in reality, controls which succeed in reducing the stock of money (or cause it to rise at a lower rate) may be rendered nugatory by a compensating change in the velocity of circulation. Indeed the very distinction between changes in the quantity of money and changes in the velocity of circulation comprises an arbitrary element of definition-what appears as a rise in the velocity of circulation under a narrow definition, may appear as a change in the quality of money, on a broader definition, which includes money substitutes.

Of these assumptions we propose to concentrate on the second, the differences between a commodity-money economy and a credit-money economy, just because we regard this as the essential element of the problem which has been largely neglected by Keynesian economists and not only by the monetarists.

It is the essence of the quantity theory of money that the supply of money is "exogenous"-that is to say, that it is determined independently of the demand. This will be the case in all circumstances in which the quantity of the money commodity (strictly speaking this involves a closed economy not trading with the outside world) - the quantity of precious metals - is given. It is also true in cases in which money has an independent supply function - *i.e.*, when the quantity of the money commodity can be brought about in this way directly generate incomes, and are closely related to the value of money in terms of goods.

Ricardo assumed for purposes of his theory that gold is produced under conditions of constant cost -*i.e.*, that the value of gold in terms of commodities is fully determined by its labour costs relative to that of other commodities. But in the case of paper money or credit money in its numerous forms (bank money) there is no such independent supply function. Credit money comes into existence as a result of bank lendings and is extinguished through the repayment of bank loans. Hence, the 'money supply' can never be in excess of demand in the sense in which the available quantity of gold can be in excess of the amount people wish to hold. At any one time the volume of bank lending and its rate of expansion is limited by the availability of credit worthy borrowers. When trade prospects are good or when the money value of the borrowers' assets (their collateral) rises as a result of a rise in prices, the demand for bank credit rises but by the same token, the credit worthiness of potential borrowers also improves, so that the supply of credit will expand automatically with the demand.

In the case of a purely metallic currency, it is possible to suppose that the supply of the money commodity increases relatively to the demand - say, as a result of the discovery of new gold money or the conquest of a new continent with a great deal of gold like the Spaniards found in America in the 16th century- in which case the

value of gold must fall relative to other commodities in order to find a 'home' for all the gold that seeks a 'home'. A change in the price level in the value of the money commodity relatively to others thus forms the adjustment mechanism which brings desired money balances (Walras "encaisse desire") into conformity with actual balances.

Endogenous Money Supply :

But there is no analogue this in the case of credit money. The "supply" of bank money cannot be assumed to vary relatively to demand, the two must always change together. It is impossible to imagine that the reviling amount of bank money should be in excess of the amount which individuals collectively desire to hold- if there was such an excess, would be extinguished through the repayment of bank loans.

In other words, in a credit-money economy the money supply is necessarily endogenous, not exogenous. This proposition is of course in sharp contradiction to the beliefs of the many adherents of the quantity theory of money who think that the exogeneity of the money supply in a credit money economy is ensured either through the numerical dependence (or strict proportionality) of bank money to the underlying "real" money (this was Walras' and Marshall's view) - paper money is in strict proportion to gold - or simply through the reserve requirements imposed on commercial banks by the central bank.

However, there is no such one way causation from the "monetary base" determined by the central bank and the size of the credit pyramid which is built on it. This is partly because the central bank can only determine the total of "base money" issued (including the notes and coins circulating with the public) and not the size of the commercial banks' reserves as such. But it is partly also because the central bank's function of "lender of last resort" (which is considered indispensable for maintaining the solvency of the banking system) makes it impossible for the central bank to set rigid limits to the amount of cash which it is willing to put at the disposal of commercial banks through rediscounts. The "discount window" can never be closed.

Keynes unwittingly contributed to Friedman's revival of monetarism by his "liquidity preference" equation, $M=L(y,r)$ where the demand for money was assumed to vary with the rate of interest, whereas the supply of money, M , was taken as an exogenous constant. This formulation puts the whole burden of adjustment to a change in the level of income, Y , on the elasticity of demand for money balances- the elasticity of the liquidity preference function, which meant that variations of economic activity will be correlated with corresponding variations in the velocity of circulation. Starting from these premises Friedman was justified in thinking that strong empirical evidence concerning the stability of the velocity of circulation-in other words, a strong empirical correlation between M and Y -is sufficient to "refute" the Keynesian hypothesis. However, it did not occur his findings may lie somewhere else-in the variability of M with the volume of borrowing which postulates a high degree of elasticity in the supply of money with respect to the rate of interest (or simply of income) and not (or not necessarily) of the demand for money (at a given level of income). However, once we realise that the supply of money is endogenous (it varies automatically with the demand, at a given rate of interest), "liquidity preference" and the behaviour of the velocity of circulation ceased to be important.

At a later stage, Friedman and his followers investigated the matter and came up with a remarkable ambiguous answer : "the alternatives contrasted are not mutually exclusive. Undoubtedly there can be and are influences running both ways" (*i.e.*, from Y to M as well as from M to Y) He then cites "five kinds of evidence" for the view that the "monthly series is dominated by positive conformity".

We found most of his "evidence" (particularly that of his book, *The Monetary History of the United States*) largely worthless or irrelevant. Moreover, we found that contrary to Friedman's frequent assertions the demand for money as a proportion of incomes (*i.e.*, the reciprocal of the velocity of circulation) is neither "stable" between countries nor stable over time except in some countries. For example, in Switzerland, Italy and Japan the money supply (on the broad definition $M3$) has been rising over the last twenty years

in relation to incomes, whilst in the US and the UK it has been falling. In 1978 the ratio of M3 (broad money) (as proportion of the GNP) was over three and a half times as large in Switzerland as in the UK. Even on the narrow definition, M1, the money supply in Switzerland was nearly three times as great as in the UK or the US as a proportion of the GNP. Yet no one would regard Switzerland as an "inflation prone" country (let alone more inflation prone) than the US or the UK.

Money Substitutes :

The traditional method by which a central bank exerts its regulating function is by setting its own re-discount rate, and keeping the market rates in certain relationship to this through open market operations. Historically, the central bank's policies were mainly motivated by the desire to protect its own reserves (consisting of gold and reserve currency holdings); it lowered the discount rate in times of rising reserves and vice versa. This policy is perfectly compatible with the "money supply" being a passive element varying automatically with the demand for credit (or the availability of creditworthy borrower's).

However, in the new monetarists' view all this is wrong. To stabilise the economy and to avoid inflation what is needed first of all is to secure a steady growth in the money supply, not a steady rate of interest. Hence the "new" policy of the Federal Reserve, was to secure a slow and steady growth of the monetary aggregates M1 and M2 by varying the reserves available to the banking system through open market operations, irrespective of the movement of the rate of interest. From that day on dramatic changes started to happen which were quite different from those expected. The money supply failed to grow at a smooth and steady rate; its behaviour exhibited a series of wriggles. The rate of interest and the rate of inflation, though both were very high at the start, soared to unprecedented heights in a very short time.

By March 1980 the rate of interest rose to 18.6 per cent and the rate of inflation to 15.2 per cent, and a little later both were over 20 per cent - which had never occurred before in the United States,

certainly not in peace-time. And there was a mushroom-like growth in new forms of making payments and new instruments circumventing the Fed's policy- through the invention of money substitutes of all kinds, the transfer of business to non-member banks or to branches of foreign banks, and so on. The Fed's reply to this was that its failures were all due to loopholes in the existing system, which must be closed. Congress obliged their friends in the Fed very quickly, passing the Monetary Control Act of 1980, supplemented by invoking the International Banking Act and the Credit Control Act.

These extended minimum reserve requirements to all deposit-taking institutions, whether or not they were member banks of the Fed, as well as to branches of foreign banks in the US. But none of this helped, as the British Radcliffe Committee foretold would happen twelve years earlier, when it said that the extension and multiplication of controls through a wider spread of banking regulations would only mean that new forms of financial transactions or intermediaries will appear which will cause the situation continually "to slip from under the grip" of the authorities.

The American monetarist experiment was a terrible failure, as was publicly admitted by Friedman and Meltzer in 1982, though insisting that it was the fault of the authorities in not being able to run a monetarist policy properly-not the fault of basic theory. Short of the old Chicago plan for 100 per cent reserves, there was certainly no way in which the authorities could have stopped the banks inducing the public to exchange more of their currency notes for deposits and thereby enlarge the lending power of the combined with a re-purchase agreement if necessary.

After a year and a half of continued failures and a chaotic volatility of every things-interest rates, exchange rates, inflation rates-the experiment was abandoned and the system returned, in effect, to the traditional policy of regulating interest rates but with a more deflationary stance; partly, we presume, to offset the inflationary force of excessive federal deficits-and cause the rest of the world to suffer (or benefit, as the case may be) from the consequences of an over valued dollar. As the former German

Chancellor Schmidt said the other day, the US government caused real interest rates to rise to higher levels than at any time since the birth of Christ.

Structure of Interest Rates :

In retrospect none of this would have happened if the Fed had studied and understood the analysis and prescription of the British Radcliffe Committee, according to which central banks should not really be concerned with the "supply of money" - it is the structure of interest rates, and not the quantity of money "which is the center-piece of monetary action". However, the committee was also of the view that the structure of interest rates, and particularly the long-term interest rates should be set by the central bank in the best interests of long-term development and not moved up and down with the changing needs of the short-term situation. But this implies (though the committee refrained from spelling out these consequences explicitly) that for the day-to-day control of the rate of expansion of bank credit, the central bank requires additional instruments such as setting the 'ceilings' for the rate of credit expansion, which is the method practiced by most European central banks as well as, we understand, by the Reserve Bank of India.

In British, when Mrs. Thatcher came to power in May, 1979, her government officially pronounced the formal adoption of the "monetarist creed" with almost the same solemnity as the Emperor Constantine when he embraced Christianity as the state religion. However, in the circumstances of British institution this proved even more difficult than in the United States, as subsequent events have shown. The Bank of England was incapable of fixing the "monetary base", let alone the size of mandatory bank reserves, or to leave interest rates to be freely determined by the market. Instead they fixed a four-year target for the growth of the money supply (on its broad definition of M3 including interest-bearing bank deposits) on a gradually shrinking basis-7-11 per cent increase in the first year, 6-10 per cent in the second year and 4-8 per cent in the fourth year; and they relied, for holding the money supply within the target range, on a steadily falling public sector deficit (as a percentage of the national income) and on varying the short-term interest rates

upwards or down wards according as the money supply moved relative to the target. (They were convinced, wrongly, in my view, that the public sector deficit is the major cause of changes in the money supply otherwise than through consequential changes in the volume of borrowing).

But the whole plan came unstuck in their first year and disastrously so in the second year. The growth in the money supply continually exceeded the target range from the beginning and it rose at an almost unprecedented rate of 22 per cent in the second financial year. At the same time the deficit of the public sector exceeded the target by 2 per cent of the GDP and by 1 per cent in next year-despite repeated cuts in public expenditure and heavy increases in the burden of taxation.

The government has thus singularly failed to carry out its stated objectives in terms of either the growth of the money supply or of the reduction in the burden of taxation or in the public sector deficit. But they have never the less succeeded (if "success" is the appropriate term) in creating a deep economic recession- are cession that goes far beyond that experienced by any other Western Industrialised country. Manufacturing output fell by 13.5 per cent in 1980 - a grater fall than in any year of the great depression of the 1930s. Industrial production in 1983 was 20 per cent lower than ten years earlier, whereas in the case of other industrial countries industrial production is considerably higher than ten years ago. There can be little doubt that the unprecedented rise in effective exchange rate of the pound sterling must have played a major role in this, causing a large fall in new orders both in the home market and abroad and an exceptionally large reduction in stocks.

The rise in unemployment from 1.2 to 3.2 millions-by 2 million or 8 per cent of the labour force in two years- together with the numerous closures of factories, actual or threatened, has undoubtedly greatly weakened trade union power and thus contributed to a slowing down in the rate of increase in wages in recent settlements. This, however, is clearly a consequence of mass unemployment due to the recession; it cannot be due to anything which has happened, or is happening, on the side of the money

supply. The "achievements" on the wage front and in the inflation rate do not provide any support for the validity of "monetarism"-quite the contrary-which does not stop government spokesman from claiming credit for it.

This experiment has thus left Friedman and the monetarists in an intellectually highly embarrassing position. Friedman has admitted that as far as the United Kingdom is concerned, the money supply is not exogenously determined by the monetary authorities but he attributed this to the "gross incompetence" of the Bank of England. Later he said or implied the same thing about his own country. However, this puts an entirely new complexion on monetarism.

It was nowhere stated in the writings of Friedman or any of his followers that the quantity theory of money only holds in countries where the monetary authorities are sufficiently "competent" to regulate the money supply. If the Bank of England is so incompetent that it cannot do so, how can we be sure that the Bank of Chile or of Argentina or Mexico - to take only the highly inflationary countries - is so competent, or rather so competently incompetent, as to make it possible to assert that the inflation of these countries was the consequence of the deliberate action of their central banks in flooding these countries with money? How indeed can we be sure that any central bank - not excluding even the German Bundesbank or the Swiss Bank - are sufficiently competent to be able to treat their money supplies as exogenously determined? And what happens if they are not? Surely we need a theory of money and prices to cover the cases of countries with incompetent central banks, such as Britain and the United States?

The acceptance of monetarist theories was largely the consequence of the glittering empirical and econometric evidence which Friedman and his followers were able to assemble concerning the close correlation between the changes in the money supply and of the level of money transactions (the money GNP) which Friedman believed was incompatible with, and thus refuted, Keynesian theory. However, he always admitted that this is only true on the supposition that the change in the money supply is the

cause of the change in the level of prices (or of total expenditure) and not the other way round. In other words, that the money supply is exogenously determined by the monetary authorities. If it is now conceded that this would not be true in all cases it would not be true in cases of countries with incompetent monetary authorities like the Fed or the Bank of England - how can we be sure that his findings have any relevance to other countries which may be tempted to control inflation by making the money supply follow an exogenous path of slow growth? The only remaining example where Friedmanite policies were given a thorough airing is Chile, but it would take me too long to explain why that country, too, must be classed among the incompetents.

In our view the proper test of competence of a central bank is how far it succeeds in ensuring that the banking system grants sufficient credit at the disposal of industry and commerce so that the true economic potential of the economy can be reasonable fully exploited without being overexploited. In other words, bank credit should expand at the right rate, neither more nor less. This is neither ensured nor prevented by the attempts to control the vagaries of the money supply.

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CHAPTER



THEORY OF MONEY

One of the important functions of money is to store value. Why do people store value. Or, what is the necessity of keeping resources in form of cash? The reason is quite obvious. People prefer to keep their resources in cash or liquid money because they feel indefinite about the future. A holding of resources in form of cash will enable them in future to use these resources in any manner as may be required by the needs of the moment. This advantage is not available when resources are hoarded in form other assets. Hence, we may define 'liquidity preference' as the preference or desire of the people to hold their wealth or resources in the form ' liquid cash money rather than in form of other assets. It is a propensity to hold which means not spending (for consumption) plus not using one's savings for investment. It is an unchangeable psychological affair. According to orthodox belief, there was no room for doubt, or uncertainty hence there was no need for holding idle balances or cash money; but according to modern thinking there is uncertainty about the future which accounts for a certain potentiality towards holding cash balances because we feel that they protect us against future uncertainties.

Lord Keynes has given four motives, which provide an incentive to liquidity. We will study them below one by one :

(1) **The Income Motive** : The entire amount of money which we earn is not spent the same day. There is some time-gap between income and expenditure. The income motive indicates that a cash balance is necessary for bridging the interval between the receipt of income and its disposal. The amount of such cash balance, however depends on (a) the amount of income, and (b) normal length of the time gap. There is some difference in the manner of payment also. The larger the interval between the paydays, the greater will be the amount of cash balance which people have to maintain. Thus, those who are paid every day, have no interval to bridge, and so they do not need to keep cash balances.

(2) **The Business Motive** : Business concerns and individuals hold bank (or cash) balances to indulge the interval between the incurring of their business or production costs and the receipt of sale proceeds. When a business expands the motive for holding cash balance also expands, and, when business integration has been achieved, the motive for holding cash balance decreases.

(3) **The Precautionary Motive** : Individuals and business concerns hold money in cash to provide for contingencies or unforeseen circumstances and also to provide for opportunities of advantageous purchases. This is known as 'Precautionary Motive'. The quantity of money required to be held to satisfy this motive depends upon (a) nature of enter- price, (b) access to credit market, (c) degree of financial conservatism, and (d) the ease with which stocks and bonds can be converted into cash. Possibility of earning an interest on the deposit strengthens the precautionary motive.

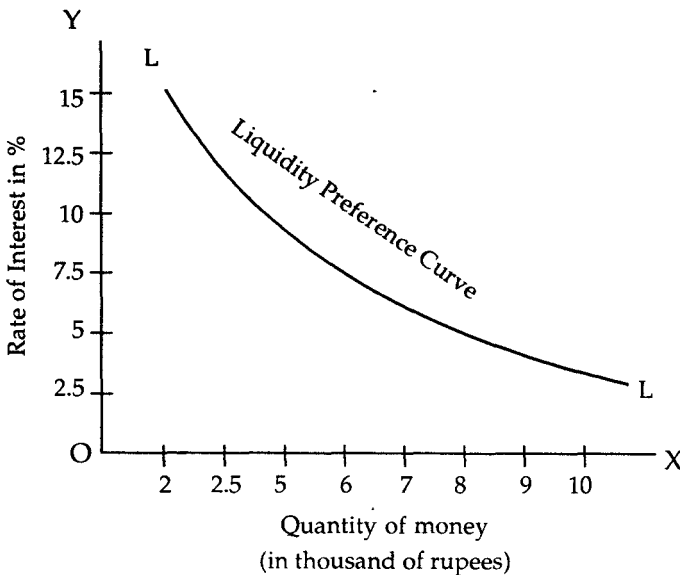
(4) **Speculative Motive** : This motive relates to the desire of the people to hold their resources in liquid form in order to reap advantages from market movements. Enterprising people keep money in cash and invest it in the purchase of securities when they think that their investment would yield high profits. If their expectations mature, they would make money. In speculative minded countries, e.g., U.S.A. people maintain as much as 50% of their resources in cash to take advantage of a turn in the market. The motive, however, is subject to wide fluctuations, which greatly affect liquidity preference.

Factors determining liquidity preference :

The above motives of liquidity preference depend for their strength upon following two main factors : (1) Rate of interest and (2) Quantity of money available for satisfying the desire to hold money.

At high rate of interest only a small amount of idle cash balances is required because higher the rate of interest the less becomes the advantage of holding cash for the above motives. But at lower rates of interest, it becomes more advantageous to hold cash and speculate. Liquidity preference is, thus interest-inelastic at high rates of interest and interest elastic at low rates of interest. It means that the propensity to hold falls or rises with a rise or fall in the rate of interest. Interest rate of interest is a balancing factor between the advantages of holding securities and the advantages of holding cash.

The relationship between the liquidity preference and interest rate is shown in the following diagram :



Inverse relationship between liquidity preference and interest rates)

LL' the liquidity preference curve shows that when rate of interest is 12.5% people hold in cash Rs. 2,000 because they feel that if they invest their money they can earn a high rate of interest. They, therefore, hold a small amount of cash to meet contingencies. When the rate of interest comes down to 5% they decide to hold Rs. 7,500 in cash because they do not lose much. Besides they expect to earn more than 5%, in advantageous purchase or speculative investment. When the rate of interest falls as low as 2.5%. Taking the entire schedule into consideration we may say that at 2.5% there is perfect elasticity in liquidity preference, *i.e.*, at this rate the public wants to hold its entire assets in the form of cash.

Relationship between Liquidity Preference and Rate of Interest :

The rate of interest will not fall below 2.5% because people's liquidity preference becomes infinite at this rate. The perfect elastic nature of the liquidity preference with regard to interest rate below a certain rate of interest, has several implications on our practical policy : (1) It tells us that the power of monetary authority, to exercise its stabilising role in depression is seriously limited. It cannot succeed in lowering the rate of interest to zero or near zero level which may be necessary to initiate recovery (2) Lower wages and lower prices accompanying a general wage cut, reduce the demand for money for transactional purposes and thus make larger quantity of money available for speculative motives, the rate of interest however would not be at all affected.

How will we explain in terms of monetary theory the possible co-existence of inflation and high rates of interest.

Inflation is a situation in which there is too much money chasing too few of commodities causing an abnormal rise in the general level prices. It has been noted that in spite of too much money during inflation the interest rates remain high. This Co-existence of inflation (too much supply of money) and high rates of interest appears to be inconsistent when we take into account the law of supply. It states that an increase in the supply of a commodity, other things remaining equal, brings about a fall in the price of that commodity. Accordingly an enormous increase in the supply of money (as

during a period of inflation) ought to bring about a fall in the rates of interest which is simply a form of price paid for the services of money. How can this inconsistency be explained? In other words, why should the rates of interest remain high in spite of the increase in the supply of money? The reasons for this phenomenon are to be found in an analysis of the 'other things', which are closely connected, with the determination of rates of interest in a given situation.

Inconsistency Explained in terms of Monetary Theory :

According to the liquidity preference theory, interest is fixed by the demand for and the supply of money. The demand for money arises out of the liquidity preference of the people to satisfy their precautionary, transactions and speculative motives. The supply depends on the monetary and fiscal policies of the state. The existence of an inflationary situation implies a state policy which injects large quantities of money into circulation. In other words, it refers to a great increase in the supply of money. If the rates of interest are to be high in spite of such an increase in the supply of money, it implies that some serious cause is operating on the side of demand which not only cancels the excess of supply but leaves a powerful impact on the market. It is, therefore, necessary for us to consider why there should be such a great rise in the demand for money during a period of inflation.

(1) Increase in Speculation : According to the Keynesian school of thought, the most important factor affecting the demand for money is the motive for speculation in capitalist society. This motive is excited most during a period of inflation because there are present bright prospects of earning a fortune within the shortest possible period by indulging in speculative activities. Besides, the risks of speculation are reduced to minimum owing to continued rise in prices which is an ordinary characteristic of inflationary conditions. Consequently, entrepreneurs can conveniently avail themselves of the opportunities so offered. Hence forward marketing becomes brisk, leading to an enormous demand for money. The entrepreneurs do not mind high rates of interest and try to get the necessary

resources to indulge in speculation. This is why the rate of interest remains high during a period of inflation.

(2) *Expansion in Business* : Further, during a period of inflation, there is brisk economic activity owing to increase in the purchasing power of the buyers. There is an unprecedented expansion of economic activities. More and more money is therefore wanted to satisfy the transactions motive. The total volume of business expands so much that each person handles more of money than before and hence the total monetary needs of the society mark a remarkable rise, even the ever increasing quantity of money becomes insufficient to satisfy those needs.

(3) *Rise in marginal Efficiency of capital* : During inflation (*i.e.*, a period of rising prices) the marginal efficiency or capital increases enormously. This rising marginal efficiency induces the entrepreneurs to undertake large scale investment to make hay while sun shines. They don't mind, paying unusually high rates of interest so long as there is good margin for profits.

Conclusion :

The above forces working on the demand side give rise to the co-existence of high rates of interest and inflation. We shall not find inconsistency between the existence of inflation and the existence of high rates of interest provided we take into account factors on demand side.

“The rate of interest is determined by the demand for idle balances in conjunction with the supply of money over and above the needs of transaction”

Classical Theory :

According to the classical school, interest is a reward for waiting or abstaining from consumption. But Keynesian Theory defines interest “as reward for parting with liquidity for a specified period” or for not hoarding. Interest is not only paid for money. The possession of money lulls our disquietude and interest is the price which has to be paid to the lender to affect the disquietude involvement in parting with the liquidity.

Rate of interest determined by the supply of and demand for money :

Keynes holds that the rate of interest is determined by the supply of and demand for money. The supply of money may be taken as given and constant because it is controlled by the banking system and the public cannot alter it. The real determinant of the rate of interest is then the demand for money or the liquidity preference.

Liquidity Preference or the Demand for idle balance :

Now liquidity preference means the demand for money for using it for those purposes which money performs in the economic system, *e.g.*, serving as a unit of account and medium of exchange. Technically we may say that the concept of liquidity preference implies the preference of the people to hold wealth in the form of liquid cash and not in other forms of assets *e.g.*, bonds, securities bills of exchange,) land, gold, capital equipment *etc.*

We must here distinguish the demand for holding money in the form of liquid cash from the demand for income. Income is a means of satisfying wants and because human wants are unlimited the demand for income is infinite. But the demand for money is limited it is not always wise to hold all the income (or wealth) in the form of liquid cash, because it involves on the one hand a cost (interest lost) and on the other hand a gain (in as much it lulls our disquietude) Every individual strikes a balance between the gain and loss and decides how much of his wealth should be held in form of liquid cash in preference to other non liquid forms.

But why do people prefer to hold liquid cash to other forms? In other words, what is the explanation of the phenomenon of liquidity preference? In this regard Keynes has given us the psychological motives which induce people to demand money or hold idle cash balances. People demand liquid cash on account of the three fundamental motives namely, the transaction motive, the precautionary motive and the speculative motive.

Dependence of the Demand for Money on interest rate and National Income :

The transaction and precautionary demands for money are mainly a resultant of the general activity of the economic system

and of the level of national income. These demands are fairly stable and constant over a short period of time as the levels of income and employment are not subject to significant changes over the short period.

The speculative demand, however, is highly responsive to the changes in the rate of interest. That is why Keynes settles down upon the speculative demand for money as the real and ultimate determinant of rate of interest. This type of demand arises due to uncertainty regarding the future rate of interest. The speculators hold cash on the basis of their individual expectations about the future rate of interest but none knows for certain what exactly the rate would be.

Let M_1 be the total quantity of money held by people for the first two motives, y the level of income and L_1 , the liquidity function corresponding to the transaction and precautionary demand for money. Then we have :

$$M_1 = L_1(y)$$

If M' be the quantity of money held for speculative purposes, r the rate of interest and L , the liquidity function relating to the speculative demand, then we have :

$$M' = L(r)$$

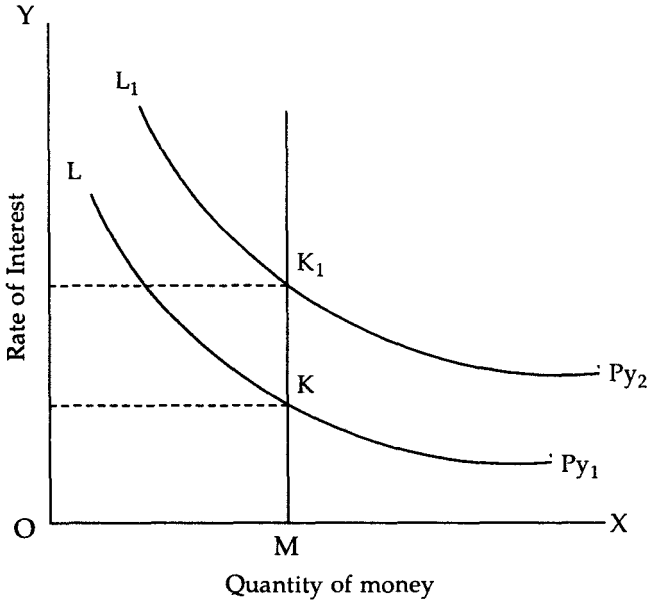
If M , be the total supply of money then the composite liquidity function can be written as :

$$M = M_1 + M' = L_1(y) + L(r)$$

$$\text{or } M = L(r, y)$$

Keynes postulates that the demand for money is on one hand positively correlated with income (that is, an increase in the level of income implies a rise in the demand for money and vice versa) and negatively correlated with the rate of interest on the other (*i.e.*, a rise in the rate of interest reduces the demand for money or an increase in the demand for money leads to a rise in the rate of interest and vice versa).

In the figure, OM represents the supply of money which may be taken to be given and constant and that is why the supply of money



curve OM is a vertical straight line. The LP y. curve represents the demand schedule of money at a level of income y. Its downward sloping shows the negative correlation between the rate of interest and the demand for money. The rate of interest r is determined at the point K where the supply of money is exactly equal to the demand for money. Now if the liquidity preference schedule rises to L'P'y, on account of an increase in income to y, the rate of interest would rise from r to r'. Similarly, if the supply of money increases, the liquidity preference schedule remaining unaltered, the rate of interest would fall.

Rate of Interest Primarily Dependent Upon Decisions About the Form in which Wealth is to be Held :

We have just seen that in the ultimate analysis the rate of interest is fixed by the demand for money particularly the speculative type. Now, in what sense do we say that the rate of interest is primarily dependent upon the decisions about the form in which wealth is to be held? Obviously, the speculative demand is nothing but the desire to hold wealth in money (or liquid cash) in preference to other forms

of wealth *e.g.* bonds securities *etc.* When the rate of interest is high, the cost of liquidity (*i.e.*, the sacrifice involved in holding wealth in money form rather than in other forms) is large. Consequently, people would reduce their money holdings. If on the other hand, the rate of interest is low the cost of liquidity would be small. Consequently, people will reduce their holdings of wealth in other forms or increase their money holdings. These actions (shifting wealth-holdings from money to non-liquid forms and, from non-liquid forms to money) react upon the rate of interest through the demand for money function. In other words, if people decide to hold more wealth in form of money, demand for money would increase and as its result (supply being constant and given) rate of interest would rise, and if people decide to hold more wealth in other forms, demand for money would decrease and as its result rate of interest would fall. Thus, the rate of interest is primarily dependent upon the decisions about the form in which wealth is to be held.

Effect of Interest-rate on the Levels of Income and Employment :

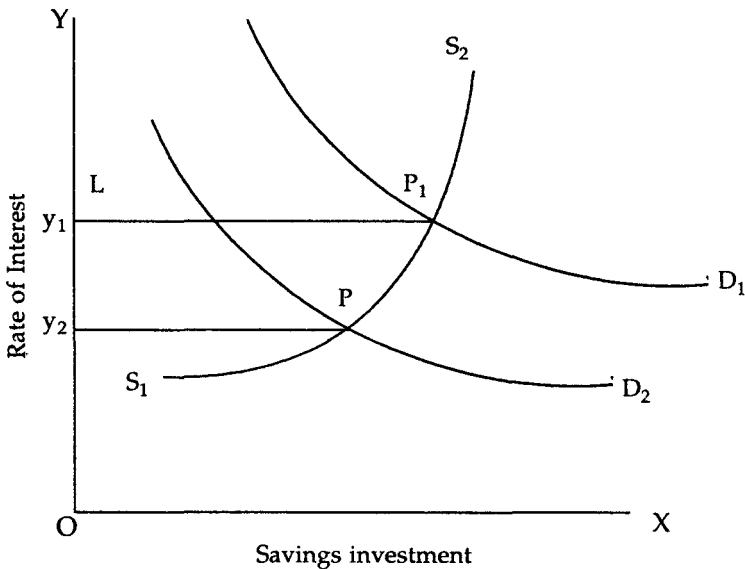
How will a change in the rate of interest affect the levels of income and employment? The answer is quite simple. A fall in the rate of interest raises the level of investment until the marginal efficiency of capital equals the reduced rate of interest. An increase in investment through the multiplier leads to a multiple increase in income and employment. On the other hand, a rise in the rate of interest lowers the level of investment until the marginal efficiency of capital equals the increased rate of interest. A decrease in investment through the multiplier leads to a multiple decrease in income and employment. Thus, the rate of interest affects the levels of income and employment through changes in the volume of investment.

According to the classical theory, "interest" is a reward for waiting or saving and abstaining from the present consumption. Like other commodities, the price for waiting (*i.e.*, rate of interest) is determined by the supply of and demand for capital. The demand for capital depends upon its marginal productivity, while marginal productivity itself depends upon the amount of investment, the amount of investment being determined at the point where the

marginal productivity equals the rate of interest. The higher the rate of interest the greater would be the propensity to save and larger would be the supply of capital.

Thus in the classical theory, the rate of interest is regarded as the equilibrating factor. If the demand for capital falls, the rate of interest is supposed to fall and thus lessen the supply of capital to correspond to the reduced demand. In case savings increase more than investment, the rate of interest is supposed to fall until savings and investment are equal again. This point is crystal clear from the diagram given below :

In the above diagram, S_1S_2 represents the supply function of savings. Its upward sloping shows that more is saved at a higher



rate of interest and vice versa. $L_1 D_1$ represents the demand curve of investment. Its downward sloping shows that the demand for capital increases with a fall in interest-rate and vice versa. The market rate of interest is determined by the intersection of these two curves. Corresponding to the point of their intersection, we get r' as the market rate of interest. In case the demand for capital falls from $I_1 D_1$ to $I_2 D_2$ the rate of interest will also fall from r_1 to r_2 .

Keynes Criticism of Classical Theory of Interest :

Keynes has attacked the classical theory on following grounds.

(1) Interest is not a reward for abstaining from consumption but for parting with liquidity. One can get interest for lending money, which he has not saved, but inherited from his forefathers. Even a man who saves, earns no interest if he hoards his savings in cash. Infact, interest is received by one who parts with his cash resources or liquidity.

(2) *The rate of interest is indeterminate* : In the classical scheme the rate of interest is infact indeterminate. Keynes has attacked the theory severely on this ground He maintains that the investment and saving schedules are not independent (as supposed by the classical economists) but are functionally interdependent. One cannot change without altering the other. When investment schedule falls from I1 D1 to I2 D2 the income will fall and (since savings are a function of interest-rate as well as income) saving will also be reduced. But the above diagram does not contain sufficient data to tell us by how much the savings would fall. We cannot, therefore, draw the savings schedule corresponding to I2 D2. Hence the rate of interest is indeterminate. This mistake of the classicists arises from their assumption of a constant level of income more spending to full employment.

(3) *The rate of interest is not the equilibrating factor* : The classical view was that the rate of interest acts as a equilibrating factor between saving and investment. But Keynes challenges this view. In his own words : "The rate of interest is not the price which brings into equilibrium the demand for resources to invest with the readiness to abstain from present consumption. It is the price which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash".

(4) *Function of money as a store of value ignored* : The classical writers took into account only two functions of money - unit of account and medium of exchange. They entirely ignored the store value function of money. This mistake of the classical economists arose from their acceptance of Say's law of markets and from their concern with the long term static equilibrium.

Reformulation of the Interest Theory by Keynes :

Having rejected the classical theory, Keynes has himself advanced an alternative theory. His alternative theory is known as the 'Liquidity Preference Theory of Interest'.

According to this theory, interest is a payment for parting with liquidity or for not hoarding and is a purely monetary phenomenon. The interest rate is determined by the supply and demand for money (or liquid cash). The supply of money or the quantity of money in circulation is controlled by the banking system and cannot be altered by public. The real determinant of the rate of interest is then the demand for money. Money in the form of liquid cash is demanded by people for three motives-transactional, precautionary and speculative. Out of these three motives, speculative motive is the most significant. The speculative demand for money is highly interest elastic and Keynes therefore attaches great significance to this as the determinant of the rate of interest. He shows that the liquidity preference or the demand for money is correlated negatively with the rate of interest and positively with the income level.

In the figures of the last question, the quantity of money in circulation (or supply of money) is represented by O.M. This can be regarded as given and constant at any point of time as money can not be created by the public. For this reason its curve Q M is a vertical straight line showing that supply of money is interest inelastic. $L P y_1$ represents the demand for money. Its downward sloping shows that the demand for money rises or falls with a fall or rise in interest rate. Since the demand for money is dependent on income-level as well, the demand curve represents the demand corresponding to a given level of income. Given the level of income Y_1 and supply of money OM_2 the rate of interest r will be determined at K_1 the equilibrium point of demand and supply. If income level rises, the demand for money or liquidity preference curve will rise to $L_1 P_1 y_1$ and interest rate will also rise to r_1 .

Superiority of Keynes' Theory over the Classical Theory :

The Keynesian Theory of interest is an improvement over the classical theory in as much as it takes into account the dynamic role

of money as a link between the present and the future. Keynes stresses the role of uncertainty and expectations. These factors significantly influence the levels of income and employment through the rate of interest. On the contrary, the classical theory ignores this dynamic role of money as a store of wealth and represents interest as a non-monetary phenomenon.

Flaws in Keynes' Theory :

Prof. Hensen has correctly shown that the Keynesian theory like the classical theory is also indeterminate. According to Keynes when the liquidity preference rises, the rate of interest would also rise. But the change in the rate of interest cannot be independent of the level of income. When the rate of interest rises, investment will fall off, as the level of investment is dependent upon the rate of interest. A fall in the level of investment would bring down the level of income, and a reduction in income implies a fall in liquidity preference with the result that the rate of interest would fall. By how much would it fall, this we do not know.

To what extent is it correct to say that the rate of interest is a highly psychological phenomenon.

Keynes describes the rate of interest as "a highly psychological phenomenon". Prof. Robertson states the same fact in these words. "The rate of interest is what it is because it is not expected to become other than what it is, if it is not expected to become other than what it is, there is nothing left to tell us why it is". In simple words we may say that the rate of interest is determined by the expectations of the public regarding the future rate of interest.

Rate of Interest - a Highly Psychological Phenomenon :

According to Keynes' Liquidity Preference Theory of interest, the rate of interest is determined by the supply of and demand for money. As the supply is given and constant at any point of time, the real determinant of the rate of interest is then the demand for money or the liquidity preference. Liquidity preference is the preference of the public to hold wealth in the form of money (or liquid cash) to other non-liquid assets like bonds, securities *etc.* Why do people demand ready cash in preference to other income yielding assets?

Here Keynes puts forwards following three broad motives for holding money : (i) the transaction motive, (ii) the precautionary motive, and (iii) the speculative motive. The demand on account of the first two motives is a resultant of the general activity of the economic system and of the level "of money income. It (demand) is however, not sensitive to changes in the rate of interest. The demand for money on account of the third motive, *i.e.*, the speculative demand belongs to an entirely different category. It is responsive to changes in the levels of income and employment and is highly responsive to interest changes. The changes in the levels of income and employment are insignificant over a short period of time. Hence if there is a change in the rate of interest, its cause is to be found in the" speculative demand rather than in the other two types of demand for money. That is why Keynes stressed speculative demand as the ultimate determinant of the rate of interest.

The speculative demand for money is a highly psychological affair. The speculators hold money "with the object of securing profit from knowing better than what the future will bring forth". If the speculator hopes the rate of interest to fall (or the security price to rise) in future, he will give up cash and purchase securities. In case his hope materializes, he will reap a capital gain. But no one has definite knowledge what the future rate of interest would actually be. It is this uncertainty which is the sole intelligible explanation of this type of liquidity preference.

Since no body knows for certain what the future rate of interest would actually be, everyone makes his own estimate on the basis of his individual expectations. Those who expect the future rate to come down the current rate will purchase bonds with the object of selling them at higher price later thus making capital gain for themselves. These individuals are called 'Bulls'. On the other hand, those who expect the future rate to go higher than the current rate, will sell bonds and acquire liquid cash. These speculators are called 'Bears' Out of these two categories of speculators, the one which is more predominant will deter-as to what the actual rate of interest would be.

It is, thus, evident that complex psychological influences work upon the rate of interest. This is exactly the reason why Keynes describes the rate of interest as a highly psychological phenomenon.

Short Term and Long Term Rates of Interest :

Over the short period, the speculative demand for money changes very widely but, over a long period, the expectations of contrary nature cancel themselves out and leave little influence upon the rate of interest. Hence the long term rate of interest is relatively stable.

In a developing country capital is scarce and yet the marginal efficiency of capital is low.

Introduction :

A developing country is a backward or poor country with a low level of per capita real income. It has following peculiar characteristics : (1) It is predominantly agricultural, (2) It is over populated, *i.e.*, population is too large relatively to its natural resources and supply of capital, and (3) stock of capital is limited and investment rate is very low (some where about 3 to 6% as compared to 15 to 18% in advanced industrial countries). India possesses all these characteristics and can, therefore, be described as an under-developed country. We witness a strange paradoxical phenomenon in underdeveloped countries - inspite of capital scarcity there, the interest rates are relatively low. How can we explain this paradox?

Inappropriateness of Keynes Theory of Interest :

The Keynesian theory of interest is inappropriate for an analysis of money and interest problems in underdeveloped countries because certain assumptions underlying the theory do not obtain there. These assumptions are :

(1) *A highly monetised economy* : In an under-developed country we come across a vast non-monetised sector where changes in interest rates do not in the least influence the nature and level of economic activity.

(2) *A highly developed organisation of money market with specialized sub markets* : In an underdeveloped country such a highly developed money markets is conspicuous by its absence. Consequently, the speculative demand for money is limited and cannot be regarded as the ultimate determinant of rate of interest as suggested by Keynes.

Explanation in possible terms of Classical Theory :

We have, therefore, to turn to the classical theory for explanation of relatively low interest rates in a developing country inspite of capital scarcity. According to this theory the rate of interest is determined by the supply of and the demand for capital. The fundamental explanation of the low rate of interest lies in that although the supply of capital is limited, the demand for capital is also limited on account of weak inducement to investment or (as Keynes would put it) low marginal efficiency of capital. The inducement to invest is weak or the demand for capital is limited due to following reasons :

(1) *Low real income of population* : The inducement to invest is low due to limited size of the market for goods and services in the under-developed country. The size of market is determined by the level of productivity and real income. Unfortunately, real income of the majority of population in under developed countries is very low. Consequently, aggregate demand is too inadequate to support large scale production with the help of capital intensive techniques.

If, for example, in place of the hand made shoes an entrepreneur introduces shoes of finer quality produced with relatively much more expensive materials and techniques, the limited demand (due to poverty of the masses) would lead him to suffer huge losses. For, demand is so limited that the plant working only a few weeks can produce enough for a whole year's consumption. Thus, the plant would have to remain idle for the rest of the year. In this way the limited demand for capital for investment nullifies to some extent the effect of the scarcity of capital and consequently interest rate remains at a relatively low level.

(2) *The relative abundance and cheapness of labour* : Another reason of limited demand for capital is that in under-developed

countries we find large scale unemployment. Consequently, labour is there much cheaper than capital. Hence it is more profitable to make a greater use of cheap labour than scarce capital so that the demand for capital is at its lowest able.

(3) *The absence of basic amenities* : Besides, amenities like electricity, roads, banking institutions, trained labour *etc.* are essential for investment in all industrial production. But these are absent in under-developed countries. If, for instance, an entrepreneur willing to set up a cloth factory were not sure of getting a regular supply of power, he would be unable to start his factory. Thus absence of facilities also limits the pace of investment.

Conclusion :

The net result is that the low demand for capital neutralizes the potential effect of the scarcity of capital on the rate of interest. We, therefore, find the paradoxical phenomenon of the relatively low rates of interest in underdeveloped countries inspite of their characteristic scarcity of capital.

Comparison of "loan-able funds" theory of interest and "Liquidity preference" theory :

Broadly speaking, we have two alternative approaches to the theory of interest - real and monetary. Under the real approach we include the Waiting or Abstinence theory, the Agio or Austrian theory, the Classical Demand and supply theory while the Liquidity Preference Theory and the Loan-able Funds Theory come under the monetary approach. The perdurability of these theories has been a subject of long and acute controversy. Prof. Hicks is of the opinion that the dispute between the upholders of two theories is a 'sham dispute'. Before giving our verdict it will be worthwhile for us to review these theories first.

Liquidity Preference Theory in Nutshell :

According to Keynes' Liquidity Preference Theory, the rate of interest is a reward for parting with liquid purchasing power (money). People want to keep money with them for three motives transactionary, precautionary and speculative. The transactionary

and precautionary demands depend very much upon the income and interest rates. The speculative demand, on the other hand, is highly interest-elastic. Its reason is obvious. With a change in rate of interest there arises a possibility of making capital gain. Thus, investment is very sensitive to changes in interest rates. It is possible to have a liquidity preference schedule showing the demand for money at different rates of interest. We may also have a supply schedule. The supply of money may or may not be affected by changes in interest rates because it depends on the decision of monetary authorities. The rate of interest is determined by the intersection of the two schedules.

Loan-able Funds Theory :

While the liquidity preference theory has a single compact formulation, the loan-able funds theory wavers because of its different statements. In a general way, the theory states that the rate of interest is determined by the supply and demand for loan-able funds. As Prof. Learner has said, we may have (i) ordinary savings and investment schedules (S and I in terms of our diagram) given below showing the savings and investment at different interest rates, and (ii) schedules showing hoarding and supply of new money (*i.e.*, L and M : L curve is sloping downwards indicating that the hoarding at higher rate of interest would be less since it costs more to hoard). Thus the supply of 'credit' (of funds available for lending) would be shown by the 'Savings' of the people Plus the 'Additions to the money supply' during that period while the demand for loans would be the 'demand for investment' plus 'demand for hoarding money'. These combined schedules (I+L and S+M) will give us the interest rate (P1B in our diagram).

It is to be noted that hoarding is equal to savings minus lending plus borrowing minus investment. In terms of symbols we may say that $S - l + b - I$. Since Savings = income Y - consumption C ($S = Y - C$) so that hoarding = $y - c - l + b - I = (y + b) - (c + l + I)$. Thus hoarding is the net change in the amount of money held (because $Y + b =$ total receipts and $c + l + I =$ total money outlays). Since hoarding or discarding occurs only when the rate of interest varies. No hoarding or discarding will occur if the rate remains constant for a sufficiently

long period. In short, within the scheme put forward by the loan-able funds theory, while savings and investment depend upon the level of interest, hoarding depends upon the changes in the rate of interest.

Reconciliation of the two Theories :

Having understood the central idea of both the theories, we can now discuss whether the two theories can be reconciled or not. In the liquidity preference theory, the speculative demand for money (other demands can be neglected in the context of developed countries since the stock of securities is very great in such countries as compared with transactionary and precautionary demands for money) depends necessarily upon the expectations of changes in interest rates. In the loan-able funds theory we now see that hoarding also depends upon the changes in interest rates. Obviously, any attempt at reconciliation of the two theories must involve showing that the savings and investment curves have no importance. Learner made an attempt in this direction. He said that "because investment and savings are always equal, therefore, investment and savings curves coincide and as such $S + M$ and $L + I$ curves will give us (through their intersection) the same rate of interest as is given by L and M curves". This attempt has, however, the defect of leaving the level of income out of account.

Dispute between the Upholders of the two Theories is a same Dispute :

By making use of his general equilibrium analysis, Hicks has attempted to show that the two theories under consideration are the same. Like all other prices, interest too is determined simultaneously with all the other unknown values in the economic system. The general equilibrium system is solved with the aid of simultaneous equations, and thus in the system we have one equation showing demand and supply of money and another showing the demand and supply of loan-able funds. One equation follows from all the others put together, and therefore, if we eliminate money equation we obtain the loan-able funds theory and if we eliminate the loan-able funds equation, we get the liquidity

preference theory. In this way, the dispute between the up-holders of the two theories is a 'sham dispute'.

Preference of one theory to the other :

Although there is hardly any dispute between the supporters of the two theories and both the theories in the end lead to same result, yet there are some good grounds on which we can prefer one theory to the other. These are :

- (1) Keynes' theory has been stated in terms of 'money stock' while the loan-able funds theory deals with 'money flow', In other words, Keynes' theory deals with the situation as it exists at a given moment of time whereas the loan-able funds theory deals with the situation over a period of time. Money theories feel that the stock approach is better as far as the rate of interest goes.
- (2) The liquidity preference theory concentrates on the motives for the demand for money and the changes therein. The loan-able funds theory is however, weak in this respect.
- (3) Keynes' theory is a part of the general determinate system while the loan-able funds theory is merely a square peg in a round hole of a general determinate system since it has developed in the context of a partial equilibrium analysis.

In the case of loan-able funds theory, saving and investment schedules depend upon the level of interest rate and hoarding respond to changes in the rates of interest. But, since savings and investment must always be equal whatever be the rate of interest or level of income, the relationship between savings and investment and interest rate has no meaning. This is also obvious from Learner's attempt pointed out above. Since savings and investment are equal, we can obtain same result regarding rate of interest from L and M curves. However, if we eliminate savings and investment schedules from our consideration, we have to face another difficulty. Suppose all savings are lent out and all borrowings are invested and no investment takes place by any discarding, so that hoarding and discarding are both zero, then the loan-able funds theory reduces itself to this simple statement that the rate of interest is determined

by the demand for and supply of savings - the classical theory of interest, while we have just seen that saving and investment schedules can be left out while considering the determination of interest.

In Keynes' theory, however, there is no such trap, because it treats savings to be interest - inelastic and the funds for investment are governed by the money supply. Savings equate themselves to investment via changes in income, and, the interest rate gets in the end determined by the supply of and, demand for money. Liquidity preference (demand for money), the marginal efficiency of capital, the marginal propensity to consume and the money supply are the four determinants of the economic system but out of these liquidity preference and money supply are the most important. Thus no contradiction is involved here and we may safely conclude that Keynes' theory is preferable to loan-able funds theory.

□□□

INDIA'S DEVELOPMENT FINANCE

Many scholars think that economic development is a phenomenon which well stands in comparison with the prepare for a war. To some extent this view is correct, as will be clear from the following discussion of the problems of Developmental Finance with those of War Finance :

(1) Both War and Development Necessitate Large Scale Expenditure : Both the situations, War and Development, make a heavy demand on mean and resources on an unprecedented scale. Labour and capital have to be deflected from their normal employment to satisfy civilian needs to the construction of war materials in the case of a war, and to the fulfilment of development targets when a country is planning for large scale economic development. The state has to pay the ruling market price for all the purchases of labour and equipment. Thus, there is an enormous increase in the expenditure of the community.

(2) War is Solely a Responsibility of the Government whereas Development is a Responsibility of the People as a Whole: As war is solely a responsibility of the state the increase in expenditure characterizing the preparation for war is almost wholly on governmental account excepting for the multiplier effect arising out of additional employment and incomes. Development expenditure

need not, however, be solely on the government account. In fact a major part of expenditure for development is likely to be in the private sector.

(3) *Where Development Proceeds on a Centrally Planned Basis there is no Difference Between the Two* : Where the government is required to initiate and sustain the process of economic development almost fully on its own account due to the lack of adequate private enterprise, the comparison between the war finance and the development finance comes closer still.

Possibility of Using Methods of War Finance to Finance Development :

When the state is wholly or chiefly responsible for a war or for development, a natural question crops up : Can the same methods of finance be suitable for both? Or, to what extent are the normal means and methods of financing a war plausible for employment for financing the schemes of economic development. The real fact is that if the two situations are entirely identical, every conceivable measure of financing a war could be used for financing the schemes of economic development. However, if the two situations differ, then the methods and means of financing would also differ.

(1) *Additional Burden* : We know that war imposes additional burden of taxation, which is not only pushed to the limits of taxable capacity but sometimes, people are forced to cut down their normal consumption in order to release resources for financing the war. Extending the same analogy to development, we may say that here the resources have to be released in favour of investment. Therefore, in the opinion of some people, the same compulsion should be applied as in war.

But the above view ignores one basic difference in the approach to a war as distinguished from the approach to the process of economic development. The heat, tension and excitement generated by a war, along with the patriotic fervour when the country's honour is at stake, would make every citizen responsible and rouse in him a spirit of utter sacrifice. Consequently, we find great readiness on the part of the community to accept voluntarily the burden of additional taxation to pay for the war. However, the same passions cannot be roused about economic development and so the people

do not so readily accept additional burden of taxation to finance development schemes. This is more true about underdeveloped countries where people are accustomed to poverty for ages together and hence do not react to development schemes with any substantial favour, Additional taxes may indeed rouse sentiments against development.

It is obvious, therefore, that the comparison between the two types of finance is helpful within certain limits, A war is expected to continue for a short period whereas economic development is a prolonged affair. Fruits of war are visible to everyone whereas the fruits of development do not accrue immediately to the entire community. Development starts from strategic sectors and thereafter it gradually spreads to the other corners of the economy. The preparedness to bear the burden of extra taxes is hence not likely to be universal.

(2) **Borrowing**: A government resorts to borrowing both from within and without in order to finance a war. Borrowing is inevitable even for financing development programmes and loans are floated both outside and inside of the country. However, it should be noted that borrowing programme for financing a war cannot be as successful as a borrowing programme for financing development schemes. Its reason is quite clear. War loans are a deadweight on the community. A war devastated economy might not be able to provide the government necessary means for their repayment. An unscrupulous country may even refuse to pay war debts. However, things are not so bad with borrowing programmes for development finance. Development loans create solid assets which yield regular income. Out of the proceeds of such income, payment of interest and repayment of principal sum is quite easy. Thus, the development loans pay their own way if they be properly utilized for productive purposes and a government need not worry much about them. War loans are easy to procure only when passion about a war works miracle to the country. External agencies will be showing greater readiness to provide for financing schemes of development rather than for financing a war.

(3) **Deficit Financing**: Modern governments do add to currency circulation out of created money in order to, finance a war and so is

the case when development schemes are to be financed. But there is a definite disadvantage of deficit financing when used to finance a war. It is bound to generate high inflationary pressures, which cannot be counteracted by increased supply of commodities. When deficit financing is applied to finance development schemes, the severity of inflationary pressure is reduced by additional production made possible through development schemes. Thus, delicate financing for development is much safer than deficit financing for war.

Conclusion :

From the above discussion it must have been clear that development finance is basically different from construction finance. A comparison between the two is instructive in so far as it brings to light the fact that development finance can be easier if reason prevails over emotions. Generally passions and emotions rule supreme when war is in being, but they recede to the background when one thinks of economic development. Hence there is constant need on the part of the planning authority to seek co-operation of the public through ample propaganda directed to appeal to its sentiments.

'Deficit Financing' Defined :

Deficit financing is a concept of comparatively recent origin. In the Western Countries, this term refers to the operation of meeting the excess of public expenditure over current revenues. In India, however, the term has been used to refer to the sale of securities to the Central Bank by the government or issue of fresh currency to meet budget deficit. The receipts from the sale of securities to the public are placed in the budget under "Capital receipts" and are not shown as forming a part of the deficit. Genuine savings are thus clearly differentiated from the deficit.

Mobilisation of Resources for Economic Development :

The Classical Economists, believing in the Say's Law of Markets, rules out the necessity of resorting to deficit financing for the promotion of income and employment, they treated the economic system to be self-adjusting. If it were given sufficient time and free

play of comparative forces, unemployment situation would correct itself through a fall in wages.

The Great Depression of the 30's demonstrated the hollowness of classical belief. Millions of Workers paraded the streets in search of work at any wage possible, but they were not successful in getting employment. Keynes reviewed all this situation carefully and in his General Theory he advanced the thesis that involuntary unemployment is not due to wage-rigidity but is due to deficiency of effective demand. To raise the level of effective demand, it is highly essential that consumption or Investment or both should be increased. This can be possible through compensatory public expenditure and the creation of budget deficit. An increment of deficit financing leads to a multiple increase in income through Hie multiplier process.

The above Keynesian principle became immediately popular in America and England and even now it is used as a major instrument of policy in times of unemployment and depression.

An Instrument of Mobilising Resources for Economic Development :

More recently deficit financing has been used as an instrument of mobilising resources for economic development. We find a large volume of surplus labour in an under-developed economy. As such the role of deficit financing in generating income and productive capacity is quite obvious. Nearly all the under-developed countries which have recently resorted to planning for economic development are extensively using deficit financing as an instrument of mobilising resources. The case for deficit financing rests upon the weakness of the weapons of taxation and public borrowing.

The efficacy of taxation weapon in an underdeveloped country is limited because (i) there exists a vests non-monetised sector In the country, (ii) the standard of living of the masses is extremely low so that Imposition of heavy taxation appears undesirable economically and politically, and (iii) heavy taxation discourage risk and enterprise so scarce and so necessary for economic growth in such countries.

Similarly, the utility of the public borrowing weapon is severely limited on account of (i) the low capacity to save, and (ii) the absence of a well organized money market so essential for the success of a borrowing scheme.

However, deficit financing immediately secures to the government sufficient funds to be utilized for productive purposes. It has certain limitations in the context of an underdeveloped economy. If carried too far, it can disrupt the whole economic basis of the society.

Deficit financing works well in case the multiplier mechanism works well. The multiplier assumes two things :- (1) Excess capacity in the capital equipment, and (2) involuntary unemployment implying a scope for wage cut. These conditions are not present in a typical under-developed economy. There we find scarcity of capital equipment and disguised unemployment. As soon as supply of money increases (through deficit financing) it is a adequately becomes disposable income and creates further demand for goods, especially the consumption goods. However, as the excess capacity is lacking in the capital equipment, output cannot be immediately increased.

Thus the Increased demand outstrips supply and Inflationary pressure comes into being. The absence of involuntary unemployment lends weight to this pressure. Under conditions of involuntary unemployment labourers accept a cut in real wages but in an under-developed country, the level of real wages is already at the minimum necessary for physical existence so that whenever the real wages fall on account of rise in prices of consumption goods, the labour gets the money wages increased through strikes, demonstrations *etc.* This further rise in wages raises the industrial costs all the more and a vicious spiral of inflation starts.

Use of Deficit Financing for Deliberate Generation of Inflation :

Deficit financing can serve to create a mild degree of inflation so essential for acceleration of economic growth. As the prices of consumption goods rise, the wages and salaries tend to lag behind due to the natural inertia of the "Contract incomes" to move in

response to changing prices. The consequent fall in real wages increases profits thus stimulating incentive to invest and causing a redistribution of income in favour of richer class (share of profits increases relatively to that of wages and salaries) whose marginal propensity to save is higher than that of the wages and salary earning class. These two factors greatly promote capital formation.

The Technique, Objectives and Limitations of Deficit Financing :

Deficit financing was once looked upon with great horror by the classical school of economists. It has, however, recently entered into the discussion of the most respectable of learned circles. No doubt certain people still believe in the virtue of a balanced budget and question the wisdom of resorting to deficit financing as a means to promote the economic development of the country. To our country, deficit financing is no longer a matter of mere academic importance, its good results have been amply demonstrated during our first two plans.

Definition of Deficit Financing :

In the western countries, the term 'deficit financing' refers to the operation of meeting the excess of public expenditure over current revenue. In India, however, the term has been used to refer to the sale of securities to the Central Bank by the Government or issue of fresh currency to meet budget deficit. The receipts from the sale of securities to the public are placed in the budget under Capital Receipts and are not shown as forming a part of the deficit. Genuine savings are thus clearly distinguished from the deficit.

It is, thus, clear that the concept of deficit financing refers to expenditure over and above the receipts during a given period of time. Thus defined, it can be practised by the State as well as private persons. When a state desires to practice deficit financing the excess revenues can be found either by drawing upon the balance of the past or by expansion of bank credit or by the creation of paper currency. The choice of a particular method would have its own economic consequences. In the context of a developing backward economy, the modes operand, of deficit financing is as important as the magnitude of deficit financing.

The Desirability of Resorting to Deficit Financing to Provide Most Urgent Sinews for Growth :

A developing backward economy badly requires funds for investment in a variety of fields on a large scale so as to initiate the process of the take off. Only a big investment can give a severe jolt of the economy out of the vicious circle of underdevelopment. However, it can only provide a fraction of the development revenues due to its low per capita income, low capacity to save. The people already stand on sub normal subsistence level. As such there is no question of tightening their belts to release funds for investment.

Of course, in backward economies we usually find great inequalities in the distribution of income and property and a class of people often indulges in a considerable amount of unnecessary consumption. To the extent the state is able to inflict curtailment of such consumption by measures of taxation and propagation of the ideals of austerity, more and more resources would be available for purposes of investment and the corresponding need for deficit financing would automatically diminish.

To achieve a given speed of development, a given volume of investment has to be undertaken within the time limitations and the limitations of real physical resources. The planners, therefore, have to find the money from the blue, if required. The desirability of deficit financing is to be judged by the urgency of economic development. If one finds that enough savings cannot be induced and mobilised through the normal methods such as taxation and borrowings, he will have no choice left but to approve of deficit financing. In that case we will have to be satisfied by the maxim that the end justifies the means especially when the means thus employed are not expected to have any evil consequences of material importance.

Likely Consequences of Deficit Financing :

For economic purposes, deficit financing comprises of created money only, created either by the banks, which expand credit or by the government by printing of legal tender currency. Money thus brought into circulation has to perform its normal function of a medium of exchange, unless it is hoarded. As deficit financing is

usually meant for financing certain schemes of development, *e.g.*, sinking of wells, construction of roads, buying industrial machinery *etc.*, we find a time gap between the completion of money into the hands of the people and completion of development schemes. Thus, extra demand is created out of created money and it unfortunately and inevitably fails to be matched by extra supply of goods. Consequently, the immediate result of deficit financing is a rise in prices especially of those goods which are purchased for development as well as those goods which are purchased by the newly employed.

Does Deficit Financing Inevitably Lead to Inflation in a Developing Economy?

Deficit financing refers to the financing of government schemes of expenditure out of created money, because the size of expenditure for a given period is not entirely covered by the total amount of revenue received. In times of war a government often resorts to use its currency powers to create legal tender for financing war schemes. Recently government have utilized their currency powers to finance development schemes.

War Time Deficit Financing in India :

During the Second World War, Indian Government was financing war supplies purchased on behalf of Britain and her allies, it was a great problem for her to find necessary resources for that purpose. In fact, the payment was to be ultimately born by British Government. It paid sterling to the credit of Indian Government in the Bank of England. Thus there accumulated sterling balances in favour of India.

The Government of India issued currency on a large scale against such balances and used the created money for financing war-requirements. The value of notes in circulation increased from 132 crores in 1933-59 to Rs. 1,163 crore in 1945-46. Throughout the war period, prices kept on rising. The General Index of Prices rose by 15%.

This rise in price is often ascribed to deficit financing as there was a concomitant variation in the volume and value of currency

and credit and the general level of prices both in the same direction. It is on account of this casual relationship between the two that deficit financing is supposed to lead to the generation of inflationary pressures in the economy.

To some extent the above conclusion may be right. But the war time rise in prices could not be solely due to deficit financing too much money pursuing too few commodities bringing about a rise in prices. There are other circumstances as well, though their role may not be so significant. Consequently, even when the volume and value of currency remains the same, there might be felt relative scarcity of goods when demand rises. Such scarcity arises on account of activation of idle resources. During a war period there is a large-scale diversion of men and materials from civilian use to military use. Hence there is a fall in supplies and demand rises much faster than supplies. As such there is a strong tendency for the prices to rise. The curtailment of imports further reinforces the price-rise. Even the pre-war level of supplies is difficult to be maintained due to many bottlenecks in production. All these circumstances take part in causing the prices to rise.

Again if there is greater maladjustment of demand and supply, of specific commodities, the greater would be the rise in prices. An example will make this point more clear. A country may resort to deficit financing for financing the production of cement. The newly employed workers will however demand more food. As such in times to come increased production of cement will not solve the problem of food shortage. This exactly happened during our first plan period. The newly employed labour demanded more consumption goods, while the production of consumer goods did not increase immediately. Hence the prices of consumer goods began to rise steeply. Fortunately the situation was eased to some extent by liberal imports of consumption goods from abroad made possible by our accumulated sterling balances.

Thus, if deficit financing is applied to selected schemes where the time lag referred to above is the minimum, development may be possible without the danger of an inflationary potential. Besides, a proper imports and exports policy can also ensure deficit financing within the limits of safety. In fact, the limit of safety depends on the

way in which deficit financing is used and operated. Considering the enormous rise in prices in recent times, it appears that deficit financing has crossed its safety limits. We must always remember that deficit financing is the medicine of the economy and not its daily bread.

Post-War Price Rise in India :

It is evident, therefore, that the war time price rise in India was only partially due to deficit financing during the war. The war time rise was carried forward because of unsatisfied pent up demand during the war time and because of other post war developments which Perpetuated this tendency further. The general index of prices continued to rise. From 275 in 1946-47, it rose to a peak figure of 435 in 1951-52. The contributory factors were :- The Korean War and the Devaluation of Indian Currency. When the Korean War ended and import controls were relaxed and bank rate was raised, the index number came down from 462 in April, 1951 to 297 In March, 1952.

The post Korean War rise in price has not been of a serious order. It has been on the whole less than 5% between 1952-1955. However, because of the development investment of the first plant the general prices index again rose to 414, in the year 1956-57. There had been an actual deficit of Rs. 420 crores during the First Five Year Plan. By the end of the Second Plan it was estimated to be of the order of Rs. 1,200 crores. As the expansion of currency still persisted, the prices kept on rising.

Deficit Financing, Need not be Inflationary :

It is to be noted that deficit financing for development purposes need not be as inflationary as the deficit financing to wage a war. The rise in prices is really brought about by the running of demand much in excess of supplies. The excess can be contributed to the time lag, which often follows between Investment and fructification of investment. If this time lag is reduced, then the tendencies for the prices to rise can be held effectively in check. Following measures may be recommended for this purpose :- (1) Financing the development of small handicrafts and consumer's goods industries, (11) financing the development of agriculture by way of distribution of better seeds, implements and fertilizers or small irrigation works.

If these measures are taken *i.e.*, if deficit financing is used for the above purposes, It would in all probability not add to the inflationary pressures, for in such cases the supply of commodities will follow close on the heels of the creation of demand due to money being in the hands of the people. Of course there may be some discrepancy between the type of demand and the type of supplies so that prices of particular commodities may show some rise.

Conclusion - Selected and Limited Deficit Financing alone is Advisable :

Experience shows that selected and limited deficit financing alone is advisable. Deficit financing would be justified only under unavoidable circumstances and only when its advantages outweigh the disadvantages. During a period of war, exigencies of a national calamity make deficit financing inevitable inspite of serious disturbances caused to the economy by too much of money. It has now become an important instrument to promote the economic development of a country. The anti-social consequences of deficit financing can be easily undone in a short time when the investments start bearing fruits. If deficit financing could be applied only to selected schemes (as may fruitfully within shortest possible time), anti-social consequences may be much reduced. Proper control of Imports and exports, proper supply of basic commodities in internal markets can go a long way to minimize the anti-social consequences of deficit financing.

Importance of Foreign Capital in the Context of Developmental Planning in India :

The problem of foreign capital in its present form came into being on the occasion of the attainment of political independence by the country in 1947. Many members in the Lok Sabha during the debate on economic affairs have advocated scrapping of foreign capital from the country lock stock and barrel. On the contrary, others have advocated to put it on fresh trial for some time more.

Historical Development and Past Contribution :

The growth of equity capital in India dates back to the 16th century and its development can be roughly divided into three stages, viz :

1. The initial period extending up to eighteenth century characterised by Merchant Capital.
2. The intermediate period, extending over the 19th Century and characterised by Industrial or Equity Capital.
3. The final period of comparatively recent growth characterised by the Loan or Finance Capital.

Foreign capital in the country in the past has been greatly helpful in its industrialisation. British capital on large scale had been pumped in the past in the plantation industry, transport and communication especially the railway. In fact it gathered momentum in the 20th century as protection was afforded to many industries after the first world war. It enjoyed an unchallenged monopolistic position in spheres of foreign exchange, banking, shipping, plantations, jute *etc.* Not only directly but also indirectly through managing agents it has come to rescue of our industries. According to an estimate, foreign capital on the eve of independence was about Rs. 550 crores, British capital being Rs. 400 crores.

Importance of Foreign Capital :

Our savings today stand at a very low level. Consequently the savings of other countries would enable us to develop the economic resources of India much faster than would be possible if we rely only on our own limited resources. It would enable us to purchase capital goods and equipment. Our own capital is not forthcoming and is not adequately developed. Hence foreign capital is urgently needed.

The advantages offered by foreign capital are : (1) It will strengthen our financial resources and help in our rapid economic and industrial advancement. (2) It will bear the heavy initial losses in the formation of new enterprises, which our developing country can ill afford at present. (3) It will create permanent capital assets in the country. (4)

It will increase employment opportunities in the country. (5) It will bring new techniques, technical knowledge and latest equipment in the country, (6) Our trade relations will develop with those countries whose capital we have borrowed. (7) It will be helpful

in developing existing natural resources. (8) Our Five Year Plans depend much for their success on foreign capital.

The use of foreign capital has been criticized on the following grounds :

- (i) Foreign capital has enabled the foreigners in the past to make huge profits while Indians looked on helplessly.
- (ii) It gave employment mostly to foreigners especially the British.
- (iii) Foreign industrialists obtained all types of concessions from the Government, which then favoured them at the cost of Indians.
- (iv) Foreign capital has tended to promote a lopsided development of our resources.
- (v) Its cost is very high.
- (vi) They have not only competed with large scale industries but have also threatened our small scale industries.
- (vii) We also owe to it extreme capitalisation of industrial power in India.

On the whole, as our own capital is not forthcoming and is not adequately developed, we may accept foreign capital under certain restrictions and caution. Many of the criticisms have now lost their significance due to the organisation of a national government in the country, which is quite fit to safeguard Indian interests. The External Capital Committee (1925) recommended that although foreign capital should be encouraged to come to India, the Government should exercise such control over foreign undertakings as would ensure that the benefits of concessions granted to industry accrue primarily to Indian enterprise.

□□□

CHAPTER



STATE FINANCES

The Indian Constitution (1950) authorises the state governments to obtain revenue from the following sources :

1. Land revenue;
2. Taxes on sales and purchase of goods except newspapers;
3. Taxes on agricultural income;
4. Taxes on lands and buildings;
5. Successions and estate duties in respect of agricultural land;
6. Excise and alcoholic liquors and narcotics;
7. Taxes on entry of goods into a local area;
8. Taxes on mineral rights subject to any limitation imposed by Parliament;
9. Taxes on consumption and sale of electricity;
10. Taxes on vehicles, animals and boats;
11. Taxes on goods and passengers carried by road and land waterways;
12. Stamp duties except those specified in the union list;

13. Taxes on luxuries including entertainment's, betting and gambling;
14. Tolls;
15. Taxes on professions, trades and callings, and employment;
16. Capital taxes; and
17. Taxes on advertisement other than those in newspapers. The non-tax revenue of State Governments include the following :
 - (A) Administrative receipts;
 - (B) Net contribution of the public sector undertakings :
 - (a) Forests;
 - (b) Irrigation;
 - (c) Electricity scheme;
 - (d) Road and water transport; and
 - (e) Industries and others.
 - (C) Other revenues;
 - (D) Grants-in-aid and other contributions. As in the case of Central Government, the revenue of the State Governments is of two types : (I) Tax Revenue, and (II) Non-tax Revenue. They may be summarised as under :

(I) Tax Revenue :

The tax revenue of the state is composed of proceeds from taxes on incomes, property and commodities. It also includes proceeds from taxes imposed and collected by the center but shared with the states. The income of the state governments from tax revenue in 1950-51 was only Rs. 280 crores. It rose to Rs. 86,000 crores in 2008-2009 (Budget). The sources of tax revenue are as follows :

(1) **Land Revenue** : From times immemorial, land revenue had been an important sources of income of the state governments, It is, the oldest of the state taxes. However, it is now only of minor importance. It is a compulsory payment and no agriculturist is exempted from it. The basis of the tax and the rates varies from state

to state. The land revenue system in a state depends upon the system of land tenure. Land tenure in different states differed widely in the past, but these differences are being gradually removed by the various land reforms which are being gradually introduced. The land revenue in different states has less variation now. The Taxation Enquiry Commission had made important recommendations regarding land revenue. The states have been advised to adopt a standard assessment on the basis of comprehensive survey and settlement operations. A sliding scale has been recommended for land revenue. Although it is levied at different rates in the different states, yet in most of the states it is charged on the net income of the farmers. The income of the states from land revenue increased from Rs. 40 crores in 1950-51 to Rs. 1710 crores (Budget) in 2008-2009.

It is said that land revenue system, as it prevails in India, violates particularly all the principles of taxation.

(2) *Agricultural Income Tax* : Under the Government of India Act 1935, the states were given the right to impose a tax on agricultural income and the same position has been maintained in the constitution of India as well. Thus the agricultural income is taxable by the respective state governments. The burden of this tax falls on the rich farmers rather than on the poor. Though agricultural income tax has been levied in most of the States in India but not with any particular success, Dr. K. N. Raj Committee found, "The significant exceptions are Kerala and Assam where agricultural income tax derived from plantations contributed more than the land revenue. It is a significant source of revenue in only a few other states, namely Mysore, Tamil Nadu and West Bengal. Over 90% of the total tax collection is accounted for from these five states." The income of the states from agricultural income tax increased from Rs. 4 crores only in 1950-51 to Rs. 199 crore in 2000-2001 (B.E).

(3) *Sales Tax or Value Added Tax* : The Act of 1935 empowered the state governments to levy Sales Tax or Value Added Tax on sales and purchases of goods. Under the Indian Constitution, in its present form, the states have exclusive power to levy tax on sales and purchases of goods other than newspapers. The Government of India has exclusive power to tax sales and purchases of goods in

the course of inter-state trade but the proceeds of any such tax must be distributed to the states in which they are collected. All the states except Jammu and Kashmir levy general sales tax on transactions of purchases and sales inside the state. Some of the states levied special taxes on sales of certain commodities, such as, motor fuels, tobacco, wine, sugarcane and jute. It is significant to note that the rates of sales tax differ from state to state. The sales tax may take several forms : (i) general sales tax and selective sales tax, (ii) multi-point and single-point sales tax, and (iii) a turnover tax or gross receipt tax. The income of the states from sales tax increased from Rs. 58.94 crores in 1950-51 to Rs. 42,100 in 2008-2009. Income from sales-tax during last few years is given below :

<i>Year</i>	<i>Income from Sales-Tax or Value Added Tax (Rs. in crores)</i>
1950-51	58.94
1955-56	76.58
1990-91	18,000.00
1995-96	35,000.00
1996-97	37,000.00
1997-98	38,120.00
1998-99	39,000.00
1999-2000	41,500.00
2008-2009	42,100.00

(4) **State Excise Duties** : The excise duties have been divided between the center and the states in one present financial setup on the revenue as well as administrative considerations. The Constitution of India provides for the power of the state governments to levy excise duties on alcoholic liquors and narcotics. Accordingly, the state governments levy excise duties on bhang, ganja, charas, opium, country made liquors and ether intoxicants. State excise duties are levied at varying rates in all the states which have not prohibited their sales. The income of the states from excise duties increased from Rs. 49.4 crores in 1950-51 to Rs. 10,100 crore in 2008-2009.

(5) **Entertainment Tax** : An entertainment tax is levied by the state governments in India on the value of tickets to places of entertainment in the state, such as, cinema, -shows, theatres, circuses, sports *etc.* The tax is collected from the owners of entertainment houses and organizers of sports activities who in turn add the amount of the tax in the price of the tickets sold by them. They are usually levied at a flat rate and the incidence is therefore, proportional to the price of the tickets purchased by the consumer. Exemptions are granted if the entire proceeds of a show are to be devoted to any religious, charitable, philanthropic or national purpose or when the show is wholly for the advancement of education, agriculture or public health. The revenue of the states from entertainment tax increased from Rs. 6.4 crores in 1951-52 to Rs. 615 crore in 2008-2009.

(6) **Stamps, Court Duties and Registration Fees** : The stamps are of two kinds : Revenue stamps and court stamps. The revenue stamps are affixed on commercial documents including hundis, whereas those who file suits *etc.* in the court of law are required to pay court fee in the form of court stamps. Thus, the state governments get considerable income through the sale of these stamps. Similarly, the state governments get some income in the shape of registration fee on the registration of properties in courts and tehsils. The revenue of the states from stamps, Court Duties and Registration Fees increased from Rs. 55.06 crores in 1951-52 to Rs. 8,879.5 crores in 2008-09.

(7) **Revenue from other Taxes** : Besides the above important taxes, the state governments get considerable revenue from other taxes, such as, motor vehicle tax, passenger tax, profession tax, electricity duty, sugarcane cess, raw jute cess, betting tax *etc.* The income of the states from such taxes in 1980-81 was Rs. 49.1 crores which increased to Rs. 1719.6 crores in 2008-2009.

(8) **Share in Union Taxes** : The central government gives a definite share to the states over the net proceeds from taxes like income tax, excise duties and estate duty. The share of each state is determined on the basis of recommendations of the latest Finance Commission. The Tenth Finance Commission in its report submitted

to the President of India on November 26, 1994 and tooled on March 14, 1995 in Parliament recommended that the states' share in the center's gross income tax collections be reduced from the existing 85% to 77.5%, while their share in the union excise duties be increased from 45 to 47.5%. The recommendations of the Tenth Finance Commission have been duly accepted and enforced by the Government of India. States' share in Central Government taxes during last few years stood as under :

<i>Year</i>	<i>Rs. in crores</i>
1951-52	54
1990-91	7,420
1995-96	17,843.3
1996-97	29,047.6
1997-98	44,100.0
1998-99	47,100.0
1999-2000	49,500.0
2000-2001	54,080.0
2008-2009	61,618.0

(II) Non-Tax Revenue :

Non-tax revenue of the states is of two types : grants received from the center, and other non-tax revenue. The non-tax revenue of the states increased from Rs. 120 crores in 1950-51 to Rs. 55,000 crores in 2000-2001 (budget). The non-tax revenue of the states is given below:

(1) **Grants from Central Government :** The central government gives grants-in-aid to the state governments. These grants are utilized for making up the revenue gap in state budgets. The grants-in-aid to the states are constantly increasing on account of increasing expenditure of the states. Besides the regular grants-in-aid, the central government gives extraordinary grants to the states for meeting extraordinary situations, such as, natural calamities like floods, droughts, famines *etc.* The share of each state is determined on the basis of recommendations of the latest Finance Commission. The Tenth Finance Commission has recommended that amount of

grants-in-aid to be given to the states should be equal to the amounts of deficits as estimated for each of the, years between 1995-96 and 1999-2000. The Government of India has duty accepted and implemented this recommendation of the Tenth Finance Commission. The non-tax revenue grants from the central governments to states rose from Rs. 2622.6 crores in 1980-81 to Rs. 64,959 crores in 2008-2009.

(2) *Other Non-tax Revenue* : Besides grants-in-aid, the state governments also receive revenue from interest receipts, dividends, income from general services, economic services, (including income from state Public Enterprises), social and community services. The revenue from other non-tax sources of the states increased from Rs. 90 crores in 1951-52 to Rs. 46,300 crores in 2008-2009.

Expenditure of State Governments

The expenditure of the state governments may be divided into (I) revenue, and (II) capital expenditure. They are given below :

(I) Revenue Expenditure :

The revenue expenditure of the state governments can be further classified under two convenient heads as (a) Development Expenditure, and (b) Non-Development Expenditure. The first type of expenditure is one which helps in the development of the states. The second one, as the name suggests, is of non-development type. Since we started planning in the country, for a long time, development and non-development expenditure of the states accounted for 50% each of the total expenditure. But during the last few years, the amount of development expenditure has exceeded non-development expenditure as is evident from the table given ahead :

Revenue Expenditure of the State Governments (Rs. in crores)

	Development Expenditure	Non-development Expenditure	Others	Total
1951-52	196	196	—	392
1980-81	10,514.7	4,088.2	204.9	14,807.8
1985-86	23,076.2	9,271.7	402.3	32,769.7

1995-96	89,275.8	54,197.4	1,530.7	1,45,003.9
1997-98	1,45,267.8	71,767.5	—	2,17,035.3
1998-99	1,75,246.1	88,795.6	—	2,64,041.7
2008-2009	1,87,501.5	1,09,422.0	—	2,96,923.5

The above table clearly shows that the total expenditure of the state governments on revenue account has increased very rapidly many times more since 1951-52 from Rs. 392 crores. The huge increase was partly due to the expenditure on government activities but also due to sharp rise in prices and wages consequent to continuous inflationary pressure during this period.

(a) Development Expenditure : All the expenses, which are incurred for the social and economic development of the respective states are included under the head 'development expenditure'. Under social services, the main heads included are education, public health, sports, arts, culture, family welfare, water supply and sanitation, housing, urban development, relief and rehabilitation of displaced persons *etc.* These services confer a positive advantage on the community and the more developed these services are, the happier and better would be the people residing in the state concerned. The states provide free and compulsory primary education; they also provide facilities for higher education and also for technical and vocational education. The single most important item of state expenditure is education, which accounts for nearly 32% of the total development expenditure. The states also establish and maintain hospitals, dispensaries *etc.*, and keep a large staff of qualified doctors and trained nurses, compounders, public health workers *etc.*

Under economic services, the main heads included are agriculture and allied services, rural development, special area programmes, irrigation, flood control, energy, industry and minerals, transport and communications, road construction, science, technology, environment *etc.* The development expenditure increased from Rs. 196 crores in 1951-52 to Rs. 1,87,501.5 crores in 2008-2009.

(b) Non-development Expenditure : The non-development expenditure consists of expenditure on the collection of the taxes

and duties (fiscal services), administrative services, interest payments, famine relief, pensions and miscellaneous general expenses. It also includes expenditure incurred on police, judiciary and jails. It is the responsibility of the state government to provide security, and maintain law and order in the state.

The non-development expenditure has also increased over the years, though not to the same extent as development expenditure. It was Rs. 196 crores in 1951-52 which increased to Rs. 4,088.2 crores in 1980-81 and further increased to Rs. 1,09,422.0 crores in 2008-2009.

Others : In addition to the above, state governments have to make every year large grants to local bodies, such as, municipalities and district boards, Zila Parishads, corporations *etc.* for meeting deficits in their budgets and their expenditure for certain essential services. In the state budgets for 2008-2009 Rs. 2,868.62 crores were provided under the head : compensation and assignments to Local Bodies and Panchayat Raj Institutions. (II) Capital Expenditure

The capital expenditure of the states has been increasing rapidly from the date of introduction of planning in our country. The capital expenditure is financed out of capital receipts, special loans and advances raised by the state along with advances and grants provided by the center to the states. Part of the capital expenditure consists of capital outlays on such development projects as multipurpose river valley schemes, schemes of agricultural research and development, irrigation and navigation, power projects, road transport, buildings, roads, water works, industrial development *etc.* Another part of the capital expenditure consists of discharge of permanent debt, repayment of loans to the center, loans and advances made to the states by others.

The capital expenditure of the states is also increasing rapidly. The trend has been very rapid ever since independence and particularly after the introduction of planning. Capital expenditure of the states has increased from Rs. 190 crores in 1951-52 to Rs. 44,952.1 crores in 2008-2009. The largest part of the total disbursement has been on development of capital outlays. Considering the development requirements of the states, the capital

expenditure of the stated is expected to increase at much faster rate in times to come.

Recent Trends in State Finances in India

Recent Trends in State Finances :

State Finances in India have undergone a number of important changes in recent years during the post-independence period. The important ones are as follows :

(1) *Rapid Increase in Revenue and Expenditure* : Since the commencement of Five-Year Plans, both revenue and expenditure of the state governments has increased considerably. There has been an increase in revenues because not only rates of existing taxes, have been enhanced but several new taxes like entertainment tax, electricity duties, taxes on vehicles *etc.* have also been introduced. Similarly, expenditures of the state governments have increased as there has been rapid increase in expenditure on both social and community services since independence, inflationary rise in the general price level has also contributed to bring about this situation.

Total revenue receipts of the state governments have increased from Rs. 400 crores in 1950-51 to Rs. 1,41,000 crores in 2000-2001 (B.E.). Similarly, the total revenue expenditures of the state governments have increased from Rs. 392 crores in 1950-51 to Rs. 2,20,153.6 crores in 2008-2009.

(2) *Sales Tax at the Top* : The emergence of sales tax as a major contributor to the income of the states is another important development. The income of the state governments during planning period from sales stood as under :

<i>Year</i>	<i>Income from Sales Tax (Rs. in crores)</i>
1951-52	54.4
1971-72	830
1980-81	4,018
1990-91	18,228
1991-92	21,552

1992-93	24,031
1993-94	28,140
1994-95	33,226
1995-96	35,693
1996-97	37,000
1997-98	38,120
1998-99	39,000
1999-2000	41,500
2008-2009	42,100

(3) *Alternative Trends in Excise Revenues* : There has been a sharp decline in revenue from state excise. It is on account of the policy of prohibition, which has been introduced completely or partially in several states. This made the financial position of several state governments very weak. As a matter of fact before the adoption of the policy of prohibition, excise revenue formed a substantial part of the total state tax revenue. State governments have been forced to look for other sources of revenue and restrict their activities. In 1951-52, the state governments received Rs. 49.4 crores from excise duties which increased to Rs. 10,100 crores in 2008-2009.

(4) *Political Announcements for Gaining Cheap Mass Popularity* : Recently, a competitive spirit of making political announcements' for getting cheap mass popularity have developed among the state governments, such as, selling rice at Rs. 2 per kilo and similarly, selling wheat at Rs. 2 per kilo. These announcements have caused heavy strain on the limited financial resources of the state governments. The object is simply to gain cheap popularity and win the public support. It is yet to be seen as to how long the state governments are going to fulfil their promises. Is it not the sign of financial bankruptcy of the state governments on account of making such promises?

(5) *Regressive* : The regressive character of state revenue has been accentuated all the more. This is mostly because of the imposition of sales tax even on necessities and the introduction of several new taxes. State excise duties are regressive in nature because most of the burden falls on the lower income group people who mostly consume such intoxicants.

(6) **Greater Reliance on Center** : On account of the rapid increase in the expenditure of state governments, they have started receiving increasing grants from the center in recent years. The recommendations of the various Finance Commissions which, have been duly accepted by the central government have substantially augmented the state revenues. For example, the Tenth Finance Commission has recommended that the grants given to state governments by the central government should be equal to the amount of deficits as estimated for each of the years between 1995-96 and 2008-2009.

(7) **Development Expenditure** : Another major recent trend is the rapidly increasing expenditure of the state governments on development. Total development expenditure of the state governments on revenue account increased from Rs. 196 crores in 1951-52 to Rs. 1,87,501.5 crores in 2008-2009. The increase is particularly in education expenditure. It is a healthy sign and should be welcomed.

(8) **Long-Term Borrowings** : As compared with previous years, the state governments are now resorting to long-term borrowings. They are doing so for financing their development projects. In this way, the strain on the future resources of the state governments is increasing. It is not a healthy sign in any way.

(9) **Diversification** : There is also a trend towards diversification. Reliance on new taxes is increasing as compared to old taxes. Similarly, diversification lies in expenditure also.

Criticism or Defects of State Finances :

State finances are subject to severe criticism from different corners. They suffer from several serious defects. The major criticisms and defects are as follows :

(1) **Regressive Taxation** : The regressive character of the state taxes is subjected to severe criticism. The poor bear the heaviest burden of state taxes. On the contrary, the rich classes escape relatively with much lower burden of state taxation. For example, a large part of the sales tax is contributed by the poor and the middle-class people;

(2) *Inadequate and Inelastic Revenue* : It is said that the state government sources of revenue are inadequate, static and inelastic. Most of the sources of revenue of state governments are not productive, such as, stamps and registration fees.

(3) *Conservative Policy* : The state governments are charged with adopting conservative policy. They have not taken adequate interest in increasing and developing new sources of income.

(4) *Excessive Non-plan Expenditure* : The state governments are charged with incurring excessive expenditure on security services like police, jail and courts, whereas the law and order situation in almost every state is deteriorating every day. There has been a rapid increase in crimes, such as, murder, theft *etc.*

(5) *Lack of Uniformity* : There is total lack of uniformity in the tax structure of the state governments. There is no co-ordination in various taxes and their rates differ from state to state, such as, sales tax. Similarly, some commodities are exempted from sales tax in some states but not in others.

Suggestions for Reforms :

Prof. G. Thimmaiah in his article on State Finances : "How to improve them", which appeared in Economic Times on 11th March, 1993 has suggested that the states should reduce their revenue deficits and generate surplus on revenue account to be utilized for plan purposes. For this, the subsidies at the state level should be phased and there should be reduction in other non-plan expenditure. As a matter of fact, a number of suggestions may be given for improving State Finances in India. The important ones are as follows :

- (1) Emphasis should be laid on increasing tax revenues of the state governments by better collections of the taxes.
- (2) The regressive character of the state taxes should be toned down.
- (3) Uniformity in the tax system should be ensured in the different states. For example, there should be uniformity in the rates of sales tax in all the states.
- (4) A better co-ordination between the finances of the state governments and local bodies should be established.

- (5) There should be economy in wasteful expenditure at the state level.
- (6) The states should reduce their revenue deficits. It can be done by improving the efficiency of the staff.
- (7) There should be reorganization of the state-level public enterprises. Emphasis should be laid on increasing their productive efficiency. It should be clearly notified that the state is not going to bear the burden of state enterprises running in losses any more. They should be asked either to increase their productive efficiency or should be closed down or handed over to private sector.
- (8) Emphasis should be laid on improving the law and order situation in the states. The law and order situation, particularly in U.P. and Bihar is terrible.
- (9) Emphasis should be laid on improving the efficiency of the state government employees. Corrupt and inefficient employees should be punished severely. It should be clearly stated that they are state government employees and not of political leaders. Short-time refresher courses should be introduced at regular intervals.
- (10) State government ministers should be refrained from making announcements involving huge funds for achieving their own political objectives and gaining cheap mass popularity.
- (11) Code, of conduct for state government ministers should be introduced. They should be asked to follow it strictly, failing which they should cease to be ministers.

Local Finance

By local finance we mean finances of local bodies in India. There is a large variety of local bodies in India. Different states have different types of local bodies with different functions. There are municipalities, taken in the sense of municipal committees or boards, in towns in all parts of the country. Some of the large cities have municipal corporations. Further, there are important trusts and development boards in a number of big cities, but as they do not

enjoy any power of taxation, they may not be considered as local bodies for one purpose. Moreover, there are notified area committees, small town committees and cantonment boards existing in many places in our country. However, they may not be considered separately because in the matter of functions they are like other municipal committees. In rural areas, we have district boards and rural boards. Rural boards operate over areas smaller than a district. District boards operate in a full district. In villages, in most states, we have village Panchayats, which have special functions assigned to them and have their own sources of revenue. In short, we have the following main four local bodies which are functioning today in our country :

- (I) Village Panchayats.
- (II) District Boards or Zila Parishads.
- (III) Municipalities.
- (IV) Municipal Corporations.

(I) Village Panchayats :

Establishment : A village panchayat is an institution in the village with a large variety of functions. The jurisdiction of a panchayat is usually confined to one revenue village, in some cases, though not very frequently, two or more small villages are grouped under one panchayat. The establishment of panchayat raj is the avowed policy of most states in India, and panchayats have to be established in all villages.

Functions : The functions of panchayats range over a wide area including judicial, police, civil, economic and so on. Thus small disputes may be disposed of by panchayats on the spot. In some states, roads, primary schools, village dispensaries *etc.* are to be managed by panchayats. In some states supply of water, both for drinking and irrigation, falls within their field of responsibility, and in some cases even productive and unproductive activities, such as, farming, marketing, storage, *etc.* are entrusted to them. Normally, panchayats are entrusted with discharging the usual functions, such as, construction of panchayat ghrahas; construction, repair and maintenance of wells for drinking water; construction of village roads and drains; provision of village lighting; construction

of buildings for primary schools; village dispensaries ; the registration of births and deaths *etc.*

Finances : Village panchayats in almost all the states have been given powers to levy taxes. However, they differ from state to state. Although the lists of tax powers of the panchayats are quite large, 'the taxes which have been widely adopted by them are : (i) general property tax, (ii) taxes on land, (iii) profession tax, and (iv) tax on animals and vehicles. In a small number of panchayats other taxes are also levied, such as, service tax, octroi, theatre tax, pilgrim tax, tax on marriages, tax on birth and deaths, and labour tax. As a matter of fact, taxes are levied by the panchayats only with the sanction of the state government, and there are certain limits in respect of tax rates which have to be observed.

(II) District Boards Or Zila Parishads :

Establishment : In rural areas, district boards or Zila Parishads are established on a district level. The territorial jurisdiction of a district board is generally a revenue district. Some of the functions of the district boards are being taken up by the state and by the village panchayats. The district boards have been replaced by Zila Parishads in most of the states, the district-level body is known as the Zila Parishad in Andhra Pradesh, Bihar, Maharashtra, Orissa, Punjab, Rajasthan, Uttar Pradesh and West Bengal, as the district panchayat in Gujarat, Zila Panchayats in Madhya Pradesh and as the District Development Council in Tamil Nadu and Karnataka.

Functions : The functions of district boards and now Zila Parishads in most of the states differ from state to state. For example, in Karnataka and Tamil Nadu, the Zila Parishad is a co-ordinating body which exercises general supervision over the working of Panchayat Samitis and advises them on implementation of Development Schemes. Besides these duties in Andhra Pradesh, the Zila Parishad has scientific executive functions in the establishment, maintenance and expansion of secondary, vocational and industrial schools. In Maharashtra, the Zila Parishad is the strongest of the panchayat raj bodies and is vested with the executive functions in various fields including Planning and Development and advising the state government. In Gujarat, Uttar Pradesh and

in West Bengal also, the Zila Parishad is vested with the Administrative Functions in various fields. In approves budgets of Panchayat Samitis in Assam, Bihar and Orissa. In the remaining states, Zila Parishad has no specific executive function and thus is supervisory and co-ordinating body only. Finances—The tax powers of district boards or Zila Parishads are extremely limited. They derive a substantial part of their revenues from the government grant-in-aid. The sources of revenue of district boards, or Zila Parishads, are as follows :

1. Grant-in-aid from the state government.
2. Land Ceases.
3. Tolls, fees *etc.*
4. Income from the property and loans from the state governments.
5. State non-plan help.
6. Grants for the central sponsored schemes relating to development work.
7. Income from fairs and exhibitions.
8. Property tax and other taxes which the state governments may authorise the district boards/Zila Parishads to levy.

(III) Municipalities :

Establishment and Functions : The municipalities are bodies or institutions which are established in urban areas for looking after local affairs, such as, sanitation, public health, local roads, lighting, water supply, cleaning of streets, maintenance of parks and gardens, maintenance of hospitals, dispensaries and' veterinary hospitals, provision of drainage, provision of primary education, organizing of fairs and exhibitions *etc.* However, all these functions are performed subject to the control of the state government.

Finances : The main sources of revenue of municipalities consist of (i) taxes on property, (ii) taxes on goods, particularly octroi and terminal tax, (iii) personal taxes, taxes on profession, trades, callings and employment, (iv) taxes on vehicles and animals, (v) theatre or show tax, and (vi) grant-in-aid from state government. However,

the average income of the municipalities is quite low and thus they cannot perform their functions efficiently.

(IV) Municipal Corporations :

Establishment and Functions : The municipal corporation, as a distinct type of municipal organisation, is confined to only a few large cities. The municipal corporations as a class have wider functions and large powers than is usually the case with the municipalities. The pattern of municipal corporations in regard to structure and organisation is more or less the same in all the states. The municipal corporations have wide powers and enjoy greater freedom as compared to municipalities. The municipal corporations are usually entrusted with the functions, such as, water supply and drainage, lighting, roads, slum clearance, housing and town planning *etc.* The rapid increase in the population of cities has definitely added to the functions of municipal corporations. Some of these functions, in some places, have been given to special and ad hoc bodies, but the responsibility of the corporations remains where no such special bodies exist. The municipal corporations have been able to perform these functions more efficiently because they have often got ample financial resources at their disposal as compared to municipalities.

Finances : The taxes levied by corporations generally include (i) taxes on property, (ii) taxes on vehicles and animals, (iii) taxes on trades, calling and employment, (iv) theatre and show tax, (v) taxes on companies, (vi) taxes on goods brought into the cities for sale, (vii) taxes on advertisements, (viii) octroi and terminal tax *etc.* The corporations have a fair degree of freedom in respect of their choice and modification of these taxes, subject of course to the maximum and minimum rates laid down by the law.

Sources of Revenue of Local Bodies

The sources of revenue of local bodies may be classified under the following two important heads :

- (I) Tax Revenue,
- (II) Non-Tax Revenue.

(I) Tax Revenue :

Local bodies have certain taxes assigned to them, but these vary from state to state. The local bodies are empowered to impose all the taxes. However, in practice all the taxes, are not imposed. In most cases, certain limits in respect of rates of these taxes have been laid down, and in some states sanction of the state government is necessary for levying particular tax. All taxes which can be levied by the local bodies are in the state list and in the constitution. The tax revenue sources of local bodies are as follows :

(1) **Taxes on Property :** (i) property tax, (ii) service 'tax, such as, water tax, drainage tax, scavenging tax, lighting tax, fire tax, (iii) betterment tax and contribution, (iv) tax on transfer of immovable property, (v) local cess, (vi) other surcharges and ceases, such as, health cess, library cess, education tax *etc.*

(2) **Tax on Goods :** It includes octroi and terminal tax.

(3) Passenger tax.

(4) Tax on Profession, Trade, Calling, Employment *etc.*

(5) Tax on Vehicles, Animals and Boats.

(6) Other Taxes, such as, theatre tax, exhibition tax, fair tax, taxes on mines *etc.*

(7) Share of taxes from the state government.

(II) Non-tax Revenue :

The non-tax revenue of local bodies consists of (i) fees, (ii) fines, (iii) income from public undertakings, such as, tramways, buses, distribution of electricity, (iv) grant-in-aid from state government *etc.*



LOCAL GOVERNMENTS FINANCE IN INDIA

Local bodies occupy a very important place in the political and economic life of a modern democratic country. These form the third layer of a federal government. Viewed in the context of integrated administrative machinery of a nation, the local bodies in India have now become an integral part of the national administrative machinery. Highlighting the importance of local bodies, Dr. R. N. Bhargava observes, "Local bodies provide a good training ground for democratic leaders and are eminently suitable for providing certain social services, such as, primary education, conservancy, control of epidemics, drainage, water supply, lighting, parks, local roads *etc.* Thus, the local bodies form an important segment of public sector." The problems which the local bodies face in the financial matters are on the one hand less acute than those faced by the state and central governments due to smallness of the functions assigned to them. But on the other hand, they are also more acute because of the direct day-to-day contact of these bodies with the citizens. This makes the task of local bodies all the more difficult. In all other respects the local finance is governed by the same principles and afflicted by the same problems as the state and central governments.

According to Taxation Enquiry Committee, "A sound system of local finance should, as a rule, rest on a sound foundation of local taxation." However, in practice we find that local bodies are entirely on the mercy of the state government in regard to their financial matters, their hands are tied. For example, take the case of providing grants-in-aid local bodies. No state government has any definite rules or principles on the basis of which such grants are given. In fact, both the size of the grant and its payment depend upon the availability of revenues with the state governments which are changing from year to year. This does not provide any security for the finances of local bodies. As a matter of fact, most of the local bodies in India are under severe financial crisis on account of heavy loans taken by them for meeting their increasing expenditure. Prof. Gyan Chand, while discussing the financial problems of local bodies has written that "The local finance in this country suffers from inelasticity, inadequacy and inequity." The analysis of this statement can be made under the following heads :

(1) Inelasticity of Sources of Income : In the Indian Constitution, there is division of taxes between the central government and the state governments. However, there is no reservation of taxes for the local bodies with the result that the local bodies are entirely at the mercy of the state government regarding the imposition of taxes. Before imposing any tax, the local bodies are required to take prior sanction from the relevant state government as to shape and size of the tax. The state government keeps the elastic sources of revenue with itself and transfers inelastic sources of revenue to local bodies. For example, in western countries land revenue and entertainment tax are considered as important sources of revenue of local bodies, but in India this source of revenue lies in the hands of the state government.

On the other hand, the local bodies in India have less elastic sources of revenue, such as, house tax, octroi, vehicle taxes *etc.* The inelasticity of the sources of the revenue of local bodies can be easily understood from the fact that during the First Five Year Plan the income of local bodies from taxes was only 3.5% of the combined total income from taxes of the state and central governments. It rose

to 4.9% in the Second Five-Year Plan and 3.8% in the Third Five-Year Plan. In 1967-68 it was only 4% of the combined total income from taxes of the state and the central governments. On the contrary, due to continuous inflationary conditions along with rising population in India, the expenditure of the local bodies is increasing rapidly. Thus almost all the local bodies in India are running in severe financial crisis and are under heavy loans. Due to inelastic financial resources they are not in a position to discharge their duties efficiently. Most of them are not in a position to make payment of even salary bills of their employees regularly.

(2) *Inadequacy of Sources of Income* : The sources of income of local bodies are not only inelastic but also inadequate. After independence due to : (i) development of cities and local areas, (ii) increase in the standard of living of the people, and above all, (iii) rapid increase in the population the activities of local bodies have increased. They are now required to perform a number of functions resulting in an enormous increase in their expenditure. On the contrary, their financial resources are very meagre because of less number of taxes and that too at a low rate'. According to the Jakarta Committee Report, "Although there is continuous increase in the functions, responsibilities of local bodies but the taxes imposed by them are the same as those of Lord Ripon's time." It is obvious that with such low level of income on the one hand and mounting expenditure on the other hand, the local bodies in India are not in a position even to render obligatory services, such as, water supply, drainage, sanitation, public health, primary education, construction and maintenance of local roads *etc.* This fact can be verified as soon as one enters a city whether in U.P., Rajasthan, Bihar or M.R Due to inadequacy of financial resources, most of the local bodies in India are running in heavy losses. At every step they are required to knock at the doors of the state government for grants. Besides the public opposition, the local bodies are required to face severe opposition from their own employees also.

(3) *Inequity of Sources of Income* : The sources of income of the local bodies are not only inadequate and inelastic but also suffer from the problem of inequity. From inequity point of view, the important problems of local bodies are as follows :

(i) *Restrictions on the Power of Taxation* : There are a number of restrictions on the powers of local bodies as to the imposition of taxes. For-example, whenever any local body wants to impose any new tax or make any alteration in the existing tax rates, prior sanction of the state government is a must. The shape and size of the relevant tax is to be determined by the state government. The state government either makes unnecessary delay in approving the tax proposals of the local bodies or even rejects them with a single stroke of pen without assigning any reason for the same. Thus the local bodies are hardly in a position to impose any new taxes. The rates of taxation too are so meager that sometimes it is difficult to meet, even the cost of collection of the particular tax.

(ii) *Absence of any Scientific Policy of providing Grants-in-aid* : Grants-in-aid are given by the state government to local bodies. It can play an important role in the finance of local bodies and their general functioning. However, it is surprising that no state has any definite rules or principles on the basis of which such grants are given to local bodies. In fact, both the size of the grants-in-aid and its payment depend upon the revenues and mercy of the state government which is changing from year to year. Further, there is lot of political interference in providing grant-in-aid to local bodies. In case, if a particular local body is controlled and dominated by a distinct political party from that of state government, it is evident that either no grant-in-aid will be sanctioned, and if sanctioned, the amount so sanctioned will be meager and a number of bottlenecks or hurdles will be created in regard to release of the funds. It is an open secret that Indian administrative machinery is famous for its red tapism throughout the world. Now every step of the respective state government is governed by political motives.

Suggestions and Recommendations :

As a matter of fact, different committees were appointed from time to time to study the finances of local bodies. These have given suggestions for the improvement and removal of bottlenecks. Among them, the most important ones are :

- (i) Local Finance Enquiry Committee, 1951;
- (ii) Taxation Enquiry Commission, 1954; and

(iii) Jakaria Enquiry Committee, 1965.

The important suggestions including relevant recommendations of the committees for solving financial difficulties and improving efficiency of local bodies are as follows :

- (1) The central government should levy terminal taxes on passengers travelling by railway, sea and air and the proceeds of the same should be allocated to the local bodies.
- (2) The proceeds of taxes on vehicles should be allocated to the local bodies by the states.
- (3) The share for Local Funds Cess out of the state property tax should be enhanced and the amount so obtained be given to the local bodies.
- (4) It must be remembered that a Local Self-Government should be based on sound foundations of local taxation. Hence, the tax imposing powers of the local bodies should be increased.
- (5) The non-tax sources of the local bodies should, be increased.
- (6) Some of the taxes should be reserved for the local bodies alone, as they have not been provided in the constitution. Of these taxes, tax on land and building, terminal taxes, taxes on advertisements in newspapers may be the main ones.
- (7) The local bodies should be compelled to exercise fully the taxation powers already lying with them.
- (8) The share of local bodies in the taxes imposed and collected by the state governments and shared with local bodies should be increased.
- (9) Grant-in-aid given by states to local bodies should be based on need, population, areas, resources, efficiency and performance and not on political basis. The basic grant-in-aid should be assured over a reasonable number of years.
- (10) The states should transfer more resources to the local bodies so that they may meet their increasing expenditure and improve their efficiency.

- (11) The system of taxation followed by local bodies should be progressive and scientific and, in no case it should have regressive effects.
- (12) In case, octroi is abolished, the loss of revenue to the local bodies should be duly compensated by the state government.
- (13) Political interference and bias in case of local bodies finance should be eliminated.
- (14) The local bodies too should increase their working efficiency and try to give maximum facilities to the public because increase in the resources of the local bodies depends mostly on public satisfaction and public co-operation. In the words of Prof. Gyan Chand, "Local bodies' finance problems in the narrow sense are not the problems of finance but actually they are problems of national reconstruction. Hence, while solving these problems we must adopt a wider view and pay attention to their higher importance....."

□□□

PUBLIC ENTERPRISES IN INDIA

Public sector refers to those organisations which are directly or indirectly managed by the government. In terms of ownership, public enterprises are those which are owned by the government, or partly, along with private individuals or institutions, but nevertheless has predominant share. Viewed in terms of management, public enterprises fall at least into three basic categories, *viz.* (i) those which are departmentally managed under various ministries; (ii) those which are controlled by a board, and (iii) those which are organized in public corporations in accordance with the provisions of the act of Parliament. According to Khera, "By public enterprises is meant the industrial, commercial and economic activities carried on by the central government or by a state government or jointly by the central government and a state government."

Role of Public Enterprises in India :

Public enterprise is only an instrument and a method, which the state could utilize with advantage in achieving its socio-economic objectives. Thus, it plays a significant role in the national economy of any country. Of course, the extent and implications of the same depend upon the context in which it operates for achieving politico-socio-economic objectives of the states.

The role of public enterprises in India is a recent one and to be precise, it mainly starts from the attainment of India's independence in 1947. In the past, the public enterprise played important but comparatively little role. It was primarily confined to public utilities— post and communications, water works, power plants, railway *etc.* It was extended for obvious reasons to defence industries and to certain monopoly production and trade. At present public sector enterprises are to be found mostly in the spheres of steel, coal, fertilizers, mining, shipping, distribution of electricity, trade, heavy chemicals *etc.*

In March end 1951, there were 5 enterprises as central non-departmental commercial and industrial undertakings with investment of, Rs. 29 crores only. At the end of March 1994, their number increased to 10240 and the capital employed reached a level of Rs. 1,59,307 crores. The growth and development of public enterprises during last few years is shown in the table given below:

Growth and Development of Central Government (Non-Departmental Commercial and Industrial Public Enterprises)

	1981-82	1990-91	1993-94	1996-97	1997-98
1. Operating enterprises	188	236	240	238	236
(i) Profitable enterprises	104	123	120	130	134
(ii) Loss-making enterprises	83	111	117	104	100
		(Rs. crore)			
2. Capital employed	21,935	1,02,083	1,59,307	2,01,496	2,23,047
3. Gross margin	4,012	18,312	27,600	—	—
4. Gross profit	2,654	11,102	18,438	30,609	36,093
5. Net profit	445	2,272	4,435	N.A.	N.A.
(i) Profit of Profit making enterprises	1,293	5,394	9,722	N.A.	N.A.
(ii) Losses of Loss-making enterprises	848	3,122	5,287	N.A.	N.A.
6. Ratio of gross margin to capital employed	18.29	17.94	17.33	N.A.	N.A.
7. Percentage of gross profit to capital employed	12.10	10.88	11.59	N.A.	N.A.
8. Ratio of net profit to capital employed	2.03	2.23	2.78	N.A.	N.A.

However, the equity portion of these projects, fixed at Rs. 3,389 crore will be Rs. 1,200 crore less than the revised estimate of Rs. 4,592 crore for 1994-95.

The increase in investment will be financed through an increase in resource generation of PSFs, which has gone up to Rs. 49,855 crore compared to Rs. 40,382 crore for the revised budget for 1994-95.

The internal resources generated by the enterprises have also witnessed a growth of Rs. 4,000 crore which is expected to touch Rs. 28,867 crore for 1995-96.

The maximum investment in the year are budgeted for the ministries of petroleum, railways, power, telecom and steel.

The expenditure budget for 1995-96 shows that the total Plan investment for petroleum ministry stands at Rs. 13,173 crore which is around Rs. 3,000 crore more than the revised estimate for 1994-95.

Investment in railway enterprises has been budgeted at Rs. 7,690 crore up from the revised estimate for 1994-95 of Rs. 6,889 crore. The telecommunications department will invest Rs. 8,372 crore in 1995-96 compared to Rs. 7,537 crore in the revised budget for 1994-95.

The ministries of petroleum, telecommunication, coal, civil aviation and railways will be the main contributors to the total internal resources to be generated by the PSEs.

The department of electronics, which had a deficit of Rs. 1.13 crore last year, is expected to generate Rs. 10.37 crore this year.

Units under the ministry of petroleum are expected to generate Rs. 13,169 crore for 1995-96, of which Rs. 8,985 crore will be through internal resources.

Undertakings covered by the ministry of power will generate Rs. 4,326 crore of resources of which Rs. 1,590 will be through internal resources.

Performance of Public Enterprises

1. Number of Public Enterprises	237
2. Capital employed	Rs. 66,100 crore

3. Net Profit	Rs. 3,800 crore
4. Employment	Rs. 90 Lakh persons
5. Use of Available Capacity	86%
6. Development of Subsidiary Industries— Number of Industries	2,200
7. Total Sales	Rs. 80,000 crore
8. Contribution to Public Treasury	Rs. 31,000 crore
9. Amount of Dividend distributed	Rs. 265 crore
10. Income from Exports	Rs. 6,600 crore
11. Receipt from Internal Resources	Rs. 8,900 crore

Role of Public Enterprises in India :

The role of public enterprises in India has come to be regarded as vitally important in recent times, particularly after the first world war the public enterprise has come to be regarded as an important vehicle to achieve socio-economic objectives. The main reasons for which this sector has been assigned a crucial role, particularly in developing countries like India are as follows :

(1) **Capital Formation** : According to Prof. Nurkse, capital formation is a basic necessity for the development of an underdeveloped country. This statement also holds true in case of a developing country like India. As a result of the growth and development of public sector, investment in the public sector units in our country has increased considerably. It" is evident from the table already given.

(2) **Strong Industrial Base** : Despite several criticisms against the public sector units, it is an admitted fact that rapid industrialisation during the period of planning in India was due to the growth and development of industries in public sector. The Industrial Revolution of the government in India reserved a number of industries (such as atomic energy, arms and ammunitions *etc.*) with the public sector in the interest of national security. The state also took the responsibility of developing key industries, such as, coal, iron and steel, mining, aircraft, shipping, fertilizers *etc.* Several industries were left for the private sector and thus both the sectors were assigned their distinct roles in the industrial development of India.

(3) **Accelerated Economic Growth** : To ensure a high rate of economic growth, it was felt that the state must actively participate in the process of rapid economic development of India. The increasing direct investment by the government in new industries as well as in existing industries would lead to a rapid pace of industrialisation.

(4) **Infrastructure Development** : Rapid industrialisation of a developing country like India depends upon the creation of infrastructure in terms of economic overheads, such as, transportation, communication, steel, power, irrigation, basic and key industries *etc.* It was left to the central government to develop them and as such most of the public sector enterprises were set up in these industries. Thus the basic rationale of public sector was to create the strong infrastructure for further economic development.

(5) **Economic Welfare** : The need of public enterprises arises out of the fundamental duty of the state to work for the economic welfare of the people. Whenever and in whatever condition the existing and available agencies fail to advance the economic welfare of the society as a whole, it is the obligation of the state to take concrete steps for this purpose.

(6) **Export Promotion** : A large number of public sector enterprises have been established to promote India's exports. In this connection the role of State Trading Corporation and Metals Trading Corporation has been commendable in regard to the Export Promotion Programme.

(7) **Full Utilisation of Resources** : Public welfare demands better and fuller utilisation of all available resources in accordance with the needs of the people. On the contrary, a private sector will choose to exploit the resources with the sole objective of maximizing its profits without concerning itself in the least for the general welfare of the people. Thus, in this respect also, the active role of the public enterprises is called for.

(8) **Equitable Distribution of Social Product** : It has also been argued that the public enterprises can be used as a means for the efficient equitable distribution of social product. If the enterprises (industry) are left entirely in the hands of the private sector, it will

lead to monopolistic tendencies and general exploitation of the masses. Thus, for equitable distribution of social product, active role of public enterprises is called for.

(9) Socialistic Pattern of Society : With the socialistic pattern of society as the objective, the sphere of state activities has been extended to a wide field of economic activities. To attain this objective, it is essential that the state should play an active role.

(10) Miscellaneous :

- (i) Removal of Regional Disparities,
- (ii) To enhance employment opportunities,
- (iii) To increase the revenue of the state,
- (iv) More Equitable Distribution of Economic Power, and
- (v) Economic Justice.

The public sector enterprises, have been largely successful in acting as an instrument of economic progress and social change. They have absorbed a wider section of the population, both skilled and unskilled.

Privatisation of Loss Making Public Enterprises :

In 2008-2009 only out of 240 public enterprises, 117 public enterprises were running in loss. The reasons for this state of affairs are many, such as, inefficient management, low productivity, undue political interference, corruption *etc.* Further, the number of sick public enterprises is also increasing rapidly. This has become a drain on the exchequer. Hence, it is argued that the public enterprises which are generally running at a huge loss should be either closed or handed over to the private sector. In this connection, the central and state governments seem to have taken a positive view. The steps taken so far are : (i) participation of private sector, (ii) handing over of those public enterprises to the private sector which are continuously running in heavy losses since long, and (iii) emphasis on improving the efficiency of loss making public enterprises by adopting modern techniques of management. We hope that the public sector enterprises will accept the challenge given to them under new liberalised economic policy of the

government. Do or die' should be the slogan of the public enterprises in India.

We conclude that we would certainly favour privatisation of those public enterprises, which are running in continuous heavy loss at least for the last 5 years in spite of constructive remedial measures of the central government.

Problems of Public Sector Enterprises in India

It is true that overall performance of public enterprises in India has been poor and unsatisfactory. A number of central government public sector enterprises (say 117 in 2008-2009 out of 240) were running in loss. The top loss making enterprises include The Indian Iron and Steel Co. Ltd., Bharat Cooking Coal Ltd., Hindustan Fertilizers Corporation Ltd., Central Coal-fields Ltd. At state level top loss making enterprises were State Electricity Boards, State Road Transport Undertakings *etc.* Thus, the financial performance of both central and state-level enterprises is quite poor and unsatisfactory. However, there is much scope for improving the performance and efficiency of the public enterprises in India provided their problems/shortcomings are solved.

Problems/Shortcomings Public Sector Enterprises in India :

The main problems/shortcomings of public sector enterprises in India are as follows :

(1) *Delay in Completion — Cost and Time Overrun* : The 316 public sector projects, with an average investment of over Rs. 20 crore each, registered a cumulative cost overrun of 71.8 per cent and time overruns ranging from between 12 and 75 months. As many as 200 projects were behind schedule which lead to higher costs, while 198 projects reported cost increases for physical and financial reasons. The study has been circulated for consideration of a committee of secretaries by the department of programme implementation. The analysis was ordered by the cabinet secretary, Mr. S. Rajagopal, in order to make a correct assessment of the problem and to take the necessary corrective action. The study has defined the physical reasons for the delay as those occurring due to change

in the scope and additions to the projects and also because of under-estimation. The financial reasons are due to price rise, devaluation, increases in taxes, higher prices demanded under special circumstances and hikes in administrative overheads. Time overruns are over and above the physical and financial overruns.

The original project cost of all the 316 projects stood at Rs. 63,287 crore. The figure has now gone up to a whopping Rs. 1,08,753 crore as per table given ahead :

Time~and Cost Slippages in Public Sector Projects

Sector	Total Costs (Rs. Cr.)			Time	
	No. of Projects	Original	Latest	Cost Overrun (%)	Overrun (in months)
Atomic Energy	4	2,320.0	4,359.1	87.9	12-18
Civil Aviation	1	958.3	2,171.9	126.5	35
Coal	58	10,757.0	15,609.7	45.1	12-144
Fertilisers	2	271.7	1,413.3	420.2	55
I&B	9	264.4	414.4	56.7	18-60
Mines	1	234.0	286.0	22.2	6
Steel and Iron Ore	6	6,217.1	16,075.8	158.6	8-56
Chem. and Petrochem	3	1,294.9	1,844.2	42.4	5-48
Petro and Natural Gas	20	9,679.9	14,127.8	46.0	3-60
Power	42	19,317.7	33,083.8	71.3	1-128
Paper, Cement and Auto	9	854.0	1,611.8	88.7	12-97
Railways	106	7,949.0	13,103.9	64.8	2-195
Surface Transport	32	2,358.0	3,716.1	57.6	4-105
Telecommunication	23	810.5	935.9	15.5	3-54
Total	816	63,287.3	1,08,753.7	71.8	

Of all the projects, fertilizer units had registered the highest cost increases, of 420 per cent and an average time delay of 55 months. The study has taken into account two public sector fertilizer projects—the original cost was Rs. 271 crore and this has gone up to Rs. 420 crore.

The second highest increase was registered by steel and iron ore units, with a cost overrun of 158 per cent. The six projects taken into account showed a cost increase from Rs. 6,217 crore to Rs. 16,075 crore with time escalations of between 8 and 56 months. One

civil aviation project that was analyzed showed a cost increase of 126 per cent—from Rs. 958 crore to Rs. 2,171 crore. This is followed by 42 units in the power sector which had contributed the highest quantum increase in terms of costs—from Rs. 19,317 crore to Rs. 33,083 crore, an increase of 71.3 per cent, with time overruns of between one and 128 months. A total of 106 project in the railways showed a cost increase of 64.8 per cent—from Rs. 7,949 crore to Rs. 13,103 crore and time delays of between two and 128 months. Projects belonging to petroleum and natural gas, chemicals and petrochemicals and coal posted an average cost increase of around 45 per cent.

According to the note, the single important reason for escalation was delays caused by civil contractors. A total of 74 projects or 32 per cent of the projects were delayed because of this reason. Delays because of land acquisition (forest and non-forest) had affected 54 projects. Fund constraints affected 40 projects and delays in the award of contracts and supply of equipment had affected 34 projects. Four factors had been identified for cost increases—general price increases, decline in the purchasing power of the rupee, higher interest costs during construction and capitalization of administrative overheads.

(2) *Defective Price Policy* : The public enterprises have to keep in mind the social implications of their price policy. Under public and political pressure they are required to keep the prices low even below the cost of production. On the contrary, due to inflationary trend all over the world including India, the prices are rising. This naturally affects their commercial profitability. As a matter of fact, the price policy of the public enterprises is subject to the regulation and control of the concerned government. Defective price policy is also responsible for heavy losses to the public enterprises.

(3) *Problem of Overstaffing* : Most of the public enterprises are overstaffed. The appointments mostly on higher posts are made on political grounds and not on need basis. They lack adequate academic, technical and professional qualifications. This factor is also responsible for low productivity, mismanagement and low profitability of public enterprises.

(4) **Over-Capitalisation** : Public enterprises suffer from the problem of over-capitalisation. The Study Team found several public sector undertakings over-capitalised, such as, Heavy Engineering Corporation, Hindustan Aeronautics, Fertilizer Corporation *etc.* The causes for over-capitalisation were : (i) inadequate planning, (ii) delay in construction, surplus machinery, expensive turnkey contracts, unsuitable location, defective purchase policy and uneconomic amenities on a liberal scale.

(5) **Low Level of Efficiency** : The level of efficiency in public enterprises is very low as compared to private sector enterprises. There are inadequate arrangements for training and education of workers. The unsatisfactory salary and wage rates on one side and the absence of incentives to staff on the other side have resulted in flight of qualified and efficient personnel from the public sector to the private sector. There is all-round labour Indiscipline among the workers and poor management-labour relations. There is also political interference in the working of the public enterprises. The managing directors usually come from the Indian Civil or Administrative Services or from the ranks of retired officials of the Ministries which lack the requisite experience and talent. These factors are responsible for low level of efficiency. The overall picture of public enterprises is black and dismal.

(6) **Under-Capacity Utilisation** : Many public enterprises in India operate in the capacity utilisation range of 50 to 75%. It is responsible for increasing cost on one side and wastage of resources on the other side. It is clear from our past experience that as soon as a loss making public enterprise is transferred to the private sector, it becomes a profit making enterprise.

(7) **Problem of Controls over Public Enterprises** : Public enterprises in India have got no free hand as these are required to work under different Ministries. Besides, they are also subject to

Parliamentary control, strict watch by Public Accounts Committee and the Auditor General. The Managers and Managing Directors have to follow Government Servants Code of conduct rules *etc.* In this way they are not free to act according to their will, without the risk of putting their service in danger. They have to work no

better than slaves to traditional and obsolete rules and regulations. Under the present circumstances no officer will be prepared to take the risk of his service.

(8) *Large Overhead Expenses* : The public enterprises in India have incurred heavy social costs on construction, maintenance and administration of townships as well as on education, hospitals *etc.* The social responsibilities in terms of so-called labour welfare and social security are more clearly reflected in public sector investment than in private sector investment. Sufficient arrangements have to be made for the transport, recreation and health of the staff. The total expenditure runs into several crores of rupees.

(9) *Miscellaneous* :

- (i) Corruption in public enterprises is increasing rapidly,
- (ii) These lack business approach aptitude,
- (iii) Public sector enterprises have failed to adopt the latest techniques of production. The existing technique is becoming obsolete day by day.
- (iv) Dominance of trade unions which care more for amenities of workers as against the working efficiency. Strike has become a common factor these days which is called on petty matters,
- (v) Many public enterprises have not laid down precise targets of production to be achieved during a given period,
- (vi) According to Late Indira Gandhi, prime minister of India, "Public sector would be meaningless if it failed profitability test and could claim no virtue unless it functioned effectively as an instrument of production and development and as a creator of new wealth." Even in a communist country like past U.S.S.R., 90% of the revenue is derived from the profits of the public enterprises. Hence, to ignore profit motive was a horrible mistake on the part of our political leaders.

Suggestions for the Solution of the Problems :

The future success of public sector enterprises and their rapid speed of progress depend on finding right and appropriate solution

of the above problems/shortcomings. In order to solve their problems and improve managerial and operational efficiency, the important suggestions including recent government measures are as follows :

1. Holding company form of organisation may be beneficial for sectors like steel, coal, petroleum *etc.*, where there are several units in one sector. Holding company will work as a link between the government on one side and individual units in a sector on the other side. 'SAIL' is a burning example of a holding company in the steel sector.
2. Efforts are being made to give sufficient autonomy by means of sufficient delegation of powers. For example, more autonomy has been given to the chairman of SAIL and Coal India Ltd. *etc.* for sanctioning investments for renewals, extension and new investments.
3. Necessary steps are being taken for setting up a separate management cadre for public sector enterprises. Recruitment, selection, training, placement, transfers *etc.* will be done accordingly.
4. An effective machinery for a periodical review and appraisal of the performance of public sector enterprises is to be set up shortly to identify the problems facing individual public enterprises and to initiate remedial measures as expeditiously as possible.
5. Necessary steps are being taken and guidelines laid down for improving management techniques in public enterprises.
6. Emphasis is being given for increasing both production and productivity in public sector enterprises.
7. The poor financial performance of the public enterprises has been a matter of wide interest and concern to all of us. The society is now not in a position to bear the burden of continuous loss making public enterprises. Hence, it has been decided either to improve the financial performance in a given time or to close down or to auction them to private sector. The process of auctioning them to private sector has been started.

8. It has been decided to set up separate research and development wings for state enterprises.
9. Sound planning is absolutely necessary for the success of public enterprise. Hence, it is necessary that all the aspects should be considered while formulating any plan.
10. Incentive schemes should be enforced. The workers doing more and better work should be adequately rewarded. Inefficient, lethargic and irresponsible workers should be penalised.
11. The principles of costing should be strictly enforced in public enterprises.
12. Political interference as to appointments, transfers, working *etc.* in public enterprises should be reduced to minimum.
13. Accountability has been introduced plant wise, month wise and product wise for output and profits (to some extent) with regard to steel plants. Memorandums of understanding (MOUs) are filled up between plant managers and the government so that accountability may be introduced in a proper manner. This will help a lot in improving their productivity. The scheme of MOU should be introduced in all the remaining public enterprises in India.
14. The government undertakes only such industries, which are absolutely essential and cannot be run efficiently in the private sector, while the rest should be left for private sector.
15. Sick units in the public sector are being referred to the BIFR.

Price Policy of Public Enterprises and Public Utilities

As a general rule, the government supplies those goods, which cannot be provided efficiently by the private sector because production is subject to decreasing costs. This is the case with public utilities, such as, electricity, water, transport, postal and communication services *etc.* These are situations, which are referred as 'natural monopolies' where competitive market cannot function because large enterprises can produce goods at lower costs, and,

therefore, a single enterprise tends to supply to the entire market. The existence of decreasing cost implies that the firm will suffer losses, if forced to operate where price equals marginal cost. Thus, the government may prefer to render the service itself and a public enterprise is substituted for the private firm. Further, a private monopolist produces goods in a limited quantity at a high price. Hence, public enterprises are favoured which intend to maximize public welfare rather than profits.

As a matter of fact when a public enterprise operates under competitive conditions, several problems of pricing arise. The major problem in such a situation is of maintenance of competition between public and private units. But most of the problems arise where public enterprises enjoy a monopoly. In this connection it should be noted that the public utilities are generally monopoly or semi-monopoly units. In fact, that is the position in most of the cases. However, the degree of monopoly differs in different cases. Under monopolistic situation, on the supply side due to absence of competing units it is difficult to make cost comparison, whereas, on the demand side there is a wide scope for discrimination and exploitation.

The degree of monopolistic element in Indian public enterprises differs from industry to industry. Firstly, there are industries, which enjoy total monopoly, such as, electricity, water, communications, railways, aircraft production *etc.* Secondly, there are industries, which enjoy semi or regional monopolies, such as, road transport, heavy electricals. Thirdly, there are industries, which are required to face nominal competition, such as, fertilizers, steel, machine tools *etc.* Lastly, there are industries which are required to face open competition, such as, soap, detergents, spices, sugar, hotels, salt, paper, electrical goods and other consumption goods. This last category is generally controlled both by the state governments and the private sector, whereas, first two categories are owned by the central government and the state governments. The third category is owned by the central government, state government and also by the private sector. In this way, public utilities enjoy the highest degree of monopoly because private sector is barred from entering these industries.

Theories of Pricing in Public Sector Enterprises :

The theories or principles of pricing which have been generally advanced in relation to price policy of public enterprises, the most important are :

- (1) No Profit No Loss Theory;
- (2) Marginal Cost of Production Theory;
- (3) Average Cost of Production Theory; and
- (4) Theory of Making Profits.

(1) **No Profit No Loss Theory** : It is a very old and traditional theory or principle of pricing. This theory or principle was evolved by the Fabians in connection with the municipal trading and even now it has its supporters. It is argued that the public enterprises are meant to serve the people rather than to make profit. Hence, they should not make any profits and should follow a policy of 'no profit no loss'. The public enterprises should distinguish themselves from private enterprises by promoting the public purpose rather than making profits. Prof. Lewis states, "If the corporation makes a profit or loss, it should be required to adjust its prices so as to eliminate profit or loss." He supports the principle on the ground that it prevents over or under expansion of the industries concerned and avoids the inflationary or deflationary tendencies. Many advocates of public enterprises have, in fact, argued that a great advantage of public ownership would be the freeing of the industries from the profits and loss account. The profit motive should be replaced by a spirit of public welfare.

In the past where state participation in economic activities was considered as a necessary evil, the above principle was applied and held true in those circumstances. But now the entire concept of state participation in economic life has changed. Now the state is required to play an important role in accelerating the rate of economic development in underdeveloped countries. Now it is not possible for the state to bear the burden of huge investment in public sector. Hence, the principle of 'no profit no loss' is inconsistent with the planned economy or a socialistic pattern of society like ours.

(2) Marginal Cost of Production Theory/Principle : The marginal cost of production theory or principle for pricing in the public utilities in a mixed economy was propounded by Prof. H. Hotelling in his article, "The general welfare in relation to problems of taxation and of railway and utility rates." The theory so as to be applicable to all enterprises (whether public utilities or otherwise) in a socialistic economy was advanced by Prof. A. P Lerner, Prof. Meade and Mr. Fleming also argued for marginal cost pricing for all public enterprises. According to this theory or principle, the prices of the commodity service should be fixed on the basis of the marginal cost of production in order to ensure an optimum allocation and utilisation of productive resources resulting in an optimum output and maximum utilisation of all factors of production. This theory advocates that the prices of the public utility services should be fixed at a level at which these are equal to their marginal cost of production. Under this approach, a public utility would expand its output until the marginal cost of the last unit offered is equal to the demand price. This theory explains how prices are determined in case of public utilities as well as in public enterprises. Theoretically speaking, it is a good theory but in practice it suffers from a number of drawbacks and thus is subject to criticism. The main drawbacks of this theory are as follows :

- (i) It is argued that where there are multiple products or services, the determination of detailed costs of each item may be costly and complicated affair.
- (ii) The argument that the principle of marginal cost pricing leads to optimum allocation of resources loses its validity once we drop the assumption of the existence of a perfect competitive market.
- (iii) It is said that the fixation of prices at a level insufficient to cover costs may lead to inefficiency in management.
- (iv) Undertakings operating under the conditions of increasing returns or decreasing costs would be confronted with a situation where average cost of production would be higher than the marginal cost of production.
- (v) In case of monopolies operating under the conditions of increasing costs, marginal cost pricing would lead to huge

profits which may be against the social objective of public enterprises.

- (vi) The marginal cost is not capable of being assessed accurately.
- (vii) The adoption of marginal cost pricing principle may involve a considerable in discrimination.
- (viii) The adoption of marginal cost pricing principle will make the determination of the investment policy of the government difficult.

Thus, the principle of marginal cost pricing does not provide a correct criterion for optimum allocation of productive resources for emerging investment policies for efficient conduct of public utilities and public enterprises.

(3) **Average Cost of Production Theory** : In actual practice, average cost pricing is widely adopted as a method of pricing in public enterprises. The post office both in U. K. and India provides typical example of average cost pricing; letters are carried to small and large distances at the same rate in spite of difference in cost. The main advantages of this principle are : (i) It is simple to administer it. (ii) Average cost pricing enables the public enterprises to recover their full costs and spares the community the burden of the additional taxation that would have been necessary to make up any losses incurred by charging cost prices in decreasing cost industries, (iii) The public enterprises are expected primarily to meet the needs, that is, to provide an optimum volume of supplies cheaply without seeking any profit, (iv) Since nobody is required to pay more for the goods he purchases than the amount it actually costs to produce those goods, there is no exploitation, (v) This is considered a more reliable criterion for investment, (vi) This ensures that the entire expenditure of the public enterprise is covered under this principle and thereby secures the viability and autonomy of the public undertaking.

The important dangers or drawbacks of the theory are : (i) The determination of average cost is not as practicable as it appears from the purely accounting point of view, (ii) It is feared that it may hide the inefficiency of an enterprise and force the consumers to

pay the full cost of an obsolete high cost plan, by removing any incentive for innovation, (iii) The average cost pricing may lead to excess capacity or undue restrictions on investments where potentialities exist.

(4) *The Theory of Making Profits* : The old concept that the private sector aims at profit while the public sector should aim at services is no more regarded valid under the present circumstances. It is now realised that with the public sector taking up significant proportion of total investment in the economy, an important source of capital formation will be dried up, if public enterprises do not make any profit at all. Capital is one of the scarcest resources in India, hence a proper return on capital employed is called for. What to say of capitalist countries like U. S. A., U. K., France, Japan, Germany *etc.*, even in communist country like the former U. S. S. R. about 90% of the revenue was derived from the profits of public enterprises only. However, maximization of profits should not be objective of the public enterprises in India, but reasonable profits should be earned by public enterprises in India so as to justify the huge capital investment employed in them. The principle of getting reasonable return should be employed while pricing products or services in the public sector enterprises in India. The earnings of the public enterprises can be used for their expansion or for financing other public enterprises or for meeting the rising expenditure of the respective governments.



CHAPTER



CO-OPERATIVE BANKS

An important segment of the organized sector of the Indian banking system is represented by a group of financial institutions collectively called co-operative banks. These are so called because they have been organized according to the provisions of the co-operative societies law of the states. According to the law, the co-operative societies may be organized for credit or for other (non-credit) purposes. In this book we shall be concerned with only credit societies.

The co-operative banking system is much smaller than the commercial banking system. At the end of March, 2009, the net total credit outstanding of commercial banks (with the commercial sector) was Rs. 48,000 crores. In comparison, the net credit outstanding of the co-operative banking system was about Rs. 9,000 crores on 31.03.2009 of the commercial bank credit outstanding. However, this comparison is not a true indicator of the relative importance of the co-operative banking system, which arises, on the one hand, from the sector of the economy it serves and, on the other hand, from the structural features of the co-operative banking system in relation to the requirements of rural finance. The major beneficiary of co-operative banking is the agricultural sector in particular and

the rural sector in general. Till about the nationalization of 14 major commercial banks in July 1969, these (commercial) banks hardly provided any credit for agriculture and other rural economic activities, and rural finance was pretty much left to moneylenders and other private sources, supplemented marginally by institutional finance from co-operatives and the government. Of the latter two, co-operatives were much the more important. Thus, till 1969 co-operative credit societies were practically the only institutional source of rural (agricultural) credit. Since then the government has adopted a 'multi-agency approach' under which both co-operative banks and commercial banks, supplemented by 'regional rural banks' are being developed and encouraged to serve the rural sector.

According to the new policy, too, the prime role in the provision of rural finance is supposed to be played by the co-operative credit system. The important reasons for this continued policy emphasis are summed up below : (i) despite several organizational weaknesses, village level primary co-operative credit societies are best suited to the socio-economic conditions of Indian villages, (ii) the existence of a vast network of such societies (called primary agricultural credit societies - PACS) throughout the length and breadth of the country which has been built over the past more than 80 years and which cannot be either duplicated or surpassed easily, and (iii) intimate knowledge of the local conditions and problems which the co-operative institutions at various levels have built up with them.

The true importance of the co-operative credit system lies in its geographical coverage - in giving credit outlets, spread over the entire country, located in villages, and easily accessible to units they are supposed to serve - and in the structure of higher financing agencies in the form of central co-operative banks (CCBs) and state co-operative banks (SCBs) and land development banks for providing long-term credit for agriculture. For any effective credit delivery system for rural areas, some such structure is essential and the co-operatives provide that structure. That is why every committee or commission that has examined the working and role of co-operative banking system in India (and there have been many in

number) has held the common view that 'cooperation remains the best hope of rural India' even though it has not been very successful so far. Therefore, all effort needs to be made to strengthen and improve the co-operative credit structure. The present chapter will be devoted to a study of this structure and its main constituents.

As the RBI's decennial surveys of rural debts and investment show, the co-operative credit societies have already become a force to reckon with, their weaknesses notwithstanding. Of the total debt outstanding of cultivator households, in 1951, only 3.7% was owed to co-operative societies; ten years later the relative share of co-operatives had grown to 11.4% and in 1971, this share had increased further to 22.0% and in 1981-82 to 28.6%.

Structure of Co-operative Banks :

A variety of co-operative credit institutions are operating in our economy. They are categorized under two main heads: agricultural and non-agricultural. Agricultural credit segment is by far the dominant part of the entire co-operative credit structure. In the field of agricultural credit there are separate institutions to meet the needs for short and medium-term credit and for long-term credit. For the former, the co-operative credit structure is three-tier and federal. At the apex is the State Co-operative Bank (SCB) in each state (co-operation being a state subject in India); at the intermediate (district) level there are Central Co-operative Banks (CCBs); and at the village level there are primary agricultural credit societies (PACS). Long-term agricultural credit is provided by land development banks, which will be discussed separately. Other constituents are discussed in this chapter.

One major feature of the co-operative credit structure is best explained at the outset. It is the paramedical shape of the three-tier structure. A large number of primary credit societies at the local level provide a very broad base to it; at the intermediate (district) level are CCBs, and the apex (state level) are SCBs. The SCBs and the CCBs are also called higher or central financing agencies (for primary societies).

The three-tier structure is interconnected through a two-way flow of funds - one (larger) flow going downward from the higher

financing agencies to the lower lending agencies and the other (smaller) flow moving in the opposite direction from lower credit agencies to the higher agencies.

The rationale of the two-way flow of funds is discussed below. The larger of the two flows is the downward direction - from a SCB to the CCBs under its jurisdiction and from the latter to the primary credit societies, which then lend to their borrowing members. A SCB does not lend directly to primary societies in areas where a CCB exists and CCB lends only to primary societies and not to their members or other individuals (except in a few cases). This is in the interest of functional specialisation, manageability, and cost effectiveness. This is also the rationale of the three-tier organizational structure. The basic need for higher financing agencies arises, because the PACS (the predominant part of the primary credit societies responsible for distributing credit to rural borrowers) are not able to raise enough funds by way of deposits from the public. About 60% of their working capital comes as loans from the CCBs, who, in turn, borrow about one-third of their working capital from higher financing agencies.

The SCBs themselves, apart from raising funds by way of owned funds (share capital and reserves) and deposits from co-operative societies and individuals and others, borrow a good deal from outside sources - mainly the RBI and NABARD. This is one (direct) way in which the RBI/ NABARD make their credit available to the co-operative banking system. In addition, the NABARD provides long-term loans to state governments for contributions to the share capital of cooperative credit institutions. It is mainly through such borrowing facilities, among other things, that the co-operative banking system is linked with the rest of the financial system in the country.

The RBI/NABARD do not and possibly cannot lend to primary credit societies whose number of 92,000 is forbiddingly large. They do not even lend directly to CCBs whose number at 350 is not too large, or not to even better run and relatively large top (say) 100 CCBs. The basic reason is the adherence to the discipline of the three-tier structure, which is hierarchical. For the same reason, the

state governments also provide funds to the co-operative credit system (as contributions to the share capital) only through the SCBs; the CCBs are not allowed to lend to each other, but keep their surplus funds with their SCB; and similarly primary credit societies are not allowed to inter-lend among themselves, but keep their surplus funds with their respective CCBs. This whole arrangement suggests that the problem of providing institutional credit to the rural sector is not merely one of earmarking at the top a certain amount of total credit for this sector, but much more importantly of having an appropriate organizational structure for supervising, managing, and executing the distribution of credit to millions of borrowers in small villages all over the country.

The reverse internal flow of funds is from the primary credit societies to CCBs and from the to SCBs. This is affected by way of contributions to the share capital (and, therefore, also to reserves on pro rata basis) of higher financing agencies - of SCBs by the CCBs and of the latter by the primary societies - and by way of deposits. The loans given by the higher financing agencies to their affiliates is linked with the share capital holding by these affiliates of the lending agency. Thus, normally a primary credit society can borrow from a CCB at most up to 10 times its contribution to the share capital of the CCB. A similar condition governs the borrowing limits of CCBs from their SCB. This kind of linking between the share capital contribution and the borrowing limit is partly to restrict borrowing by the lower level institutions, partly to raise funds for the higher financing agencies that lend only to affiliated banks and societies and not to individuals, and partly to create stakes of the lower level institutions in the health and vitality of those above them.

Besides, lower-level institutions are needed to keep all their surplus funds on deposit with those a step above them and not inter-lend among themselves. This also represents a reverse flow of funds in the upward direction within the co-operative banking system. This is to ensure better allocation of funds within each district and each state. Such inter-bank deposits within the co-operative banking system are a large proportion (almost 40%) of its total deposits.

A phenomenon worth noting is the net reverse flow of funds from the co-operative banking system to the government (state governments). It is generally thought that the government is the net lender of funds. This is not correct; instead, the government is the net debtor to the co-operative banking system.

First, a large part (about 50%) of the government's financial assistance in the form of its contribution to the share capital of societies is advanced by the NABARD second, the co-operative banking system (including LDBs) provides funds to the government by way of investment in its securities. For SCBs and CCBs, such investment is required by the RBI under its 'Statutory Liquidity Ratio' requirement. Since total investment outstanding in government securities by the co-operative banks is generally greater than the total financial contribution outstanding of the government to the system, there is net withdrawal of funds by the government from the system. If account is taken of the NABARD's tied credit to the government for assistance to the cooperative banking system, the government's withdrawal from the latter rises further.

We now study the individual constituents of the short-term co-operative banking system. SCBs are discussed briefly. Manor attention is devoted to PACS, the co-operative credit agencies that deal directly with the rural population.

State Co-operative Banks :

State Co-operative Banks (SCBs) constitute the apex of the three-tier co-operative credit structure, organized at the level of individual states. At the end of June 1985, there were 28 SCBs, 14 of which were scheduled banks. The SCBs occupy key position in the co-operative credit structure, as (i) it is only through them that the RBI provides credit to co-operatives, (ii) they operate as 'balancing centers' for CCBs, making surplus funds of some CCBs available to other CCBs, as CCBs are not allowed to borrow and lend among themselves, and (iii) they raise funds on their own to make them available to the CCBs and through them or directly to primary societies in such districts which CCBs are not in operation. Besides financing the affiliated banks and societies, the SCBs exercise control and

supervision over their operations and provide leadership and guidance to the co-operative movement in their respective states.

At the end of June 1985 the working capital of Rs. 4850 crores was derived largely from owned funds (Rs. 550 crores), deposits (Rs. 3,000 crores) and borrowings (Rs. 800 crores) from RBI/NABARD. The actual borrowing drawn and repaid during any year are much larger. The share capital in owned funds is raised largely (70%) from affiliated or member co-operative societies, including CCBs, and practically the rest from the state government concerned. The deposits also are held largely by co-operative societies who contribute roughly 80% of them.

The SCBs also are subject to the CRR and SLR requirements of the RBI, but only at their minimum levels of 3% and 25% respectively of their total net liabilities.

The SCBs lend almost entirely to co-operative societies - CCBs and primary societies - mostly as short-term loans (mainly) for seasonal agricultural operations. About half of the medium-term credit is simply short-term credit converted into medium-term loans to facilitate repayment by borrowing societies; the rest is for various agricultural and non-agricultural purposes such as purchase of pump-sets, sinking or repair of wells, etc. In 1984-85 the loans issued were about Rs. 4,400 crores. The year had ended with over dues to demand of about 10%.

Central Co-operative Banks :

The Central Co-operative Banks (CCBs) constitute the intermediate rung in the three-tier co-operative credit structure of which a SCB is the apex and primary credit societies in a state are the base. At the end of June, 1997 there were 350 CCBs, with more than 8,000 offices. Their main function is to lend money to affiliated primary societies. Their total working capital of about Rs. 8,000 crores was derived mainly from deposits (54%), borrowing and other liabilities (34%) and owned funds (12%). The share capital is raised largely from affiliated co-operative societies and the rest (about 30%) from state governments. The societies contribute to the share capital, as their borrowings are linked to their share-holdings

(mostly in the ratio of 10:1). As deposit-holders, individuals and others lead the co-operative societies by nearly a margin of 2:1. Rs. 2,300 crores of borrowing had come from the RBI/NABARD and SCBs. Besides, the RBI/NABARD give long-term loans to state governments to enable them to contribute to the share capital of CCBs.

The loans and advances of CCBs are almost entirely to co-operative societies. During 2008-2009 they had amounted to about Rs. 6,450 crores. About 75% of these loans are short-term and the rest medium term, and mostly for agricultural purposes. The bulk of medium-term loans are conversion/replacement/rescheduled loans.

The over dues to demand ratio at 37% was very high. The reasons for such high over dues ratio are best summed up thus: "Apart from natural calamities such as floods, drought, etc., affecting the repaying capacity of borrowers, the poor recovery performance (of CCBs) can be attributed to the inadequate or inefficient supervision exercised by the banks, the poor quality of the management of societies and banks, absence of linking of credit with marketing, reluctance to coercive measures, or where resorted to, the inability of the machinery to promptly execute the decrees.

Primary Agricultural Credit Societies (PACS):

PACS occupy a predominant position in the co-operative credit structure and form its base. A PACS is organized at the grass roots level of a village or a group of small villages. It is this basic unit which deals directly with the rural (agricultural) borrowers, gives them loans and collects repayments of loans given. It serves as the final link between the ultimate borrowers on the one hand and the higher financing agencies, namely the SCBS, and the RBI/NABARD on the other hand. As such, the health and strength of the co-operative credit movement depends crucially upon the health and strength of these societies. But, despite much official effort and support, and numerical expansion of the PACS in membership, working capital, loans given and other activities, their health and working leave much to be desired.

At the end of June, 2009 there were 92,000 PACS. These societies covered about 90% of 5.8 lakh villages. Their membership of 6.9 crores covered about 50% of the total estimated population of about 14 crores of rural households. More than half of the members of PACS are persons of small means - small farmers, agricultural labourers and rural artisans and about 25% of them belong to scheduled castes and tribes. All these are very strong features of the co-operative credit organization, as it alone provides the vast network of institutional credit agencies throughout the length and breadth of the country of subcontinental size, covering the large bulk of Indian villages.

The working capital of the PACS is derived mainly from borrowings from the CCBs and in smaller proportions from owned funds and deposits. That the PACS have failed to attract/deposits is not so much a reflection of low savings habits of the rural population as a reflection of the availability of better asserts to rural savers in terms of both rate of return and riskiness. The richer farmers either invest their savings directly in physical assets or lend them directly as agriculturist moneylenders to others in the village or hold them in deposits with banks or post offices. Only the residual savings of those households come to the PACS who want to borrow later from these societies or who want to wield influence in the actual working of the societies. To attract more deposits, these societies must be in a position to pay higher interest rates on their deposits than offered by other institutions and must inspire greater confidence regarding safety of deposits with them. For this, the societies must be managed efficiently as well as honestly.

High net borrowings from CCBs show that PACS act mainly as Distributional channels for funds mobilised elsewhere. Even this role is not played well by them, as they suffer from a very high ratio (of more than 40%) of over dues to loans outstanding/demand.

Only the members of a PACS are entitled to borrow from it. Most loans are for agricultural purposes and are short-term. Medium term loans for such purposes as sinking or repair of wells, purchase of machinery (mostly pump sets, for irrigation) and cattle are also given. But consumption loans, given mostly to landless labourers,

artisans and marginal farmers, are negligible. The share of loans given going to weaker sections is usually about 40% of loans. The amount of loans and advances outstanding at the end of June 1985 was about Rs. 4,000 crores.

A varying number of PACS also undertake not credit activities such as handling the supply of farm requisites, distribution of consumer goods among their members, constructing godowns, marketing of agricultural produce and the processing of it.

Deficiencies and Remedies :

Any number of committees and study groups have enquired into the working of the co-operative banking system and found uniformly the PACS the weakest link in the structure. Despite all the effort that has gone into strengthening these societies into strong and viable units, the position continues to be highly unsatisfactory so that not all earn profits or have full-time paid secretaries/managing directors. While there is not complete unanimity about the test of viability, the two indicators of it used in the previous sentence are not without merit.

The major deficiencies of the PACS and their credit and the steps necessary to remove them are discussed briefly below.

1. Organizational Weakness : At the primary level, the co-operative credit structure has twofold weakness:

(a) inadequate coverage; and (b) weak units. Though geographically, active PACS cover about 90% of 5.8 villages, there are parts of the country, especially in the northeast, where this coverage is very low. Further, the rural population covered as members is only 50% of all the rural households. This inadequacy of coverage itself is attributable to the financial and organizational weakness of individual PACS. In a sense, they are caught in a vicious circle: they are weak because of inadequate membership and they do not attract enough membership because they are weak. This vicious circle must be broken through policy measures of reorganization of PACS. We shall study about them a little later.

A distinction needs to be made between nominal coverage as given by mere membership and 'effective coverage' (in the RBI's

terminology) as given by the proportion of borrowing members in the total membership. On the latter criterion only in the four states of Punjab, Haryana, West Bengal and Tamil Nadu is the effective coverage of 50 per cent or more. Such coverage is much lower in U.P. and Bihar. Better criteria than the one of 'effective coverage' (used by the RBI) would be (i) borrowing members as a proportion of the rural households, (ii) the average amount of loan issued per borrowing member, and (iii) the proportion of loans going to the weaker sections. On these criteria, though a single composite index cannot be easily constructed, the states of Maharashtra, Gujarat, Punjab, Haryana and Tamil Nadu are found to fare better than other states.

Why is the borrowing membership low in the PACS? In the judgment of the Banking Commission which still holds goods, in most cases, one or more of the following reasons are responsible for the low borrowing membership: (i) defaults of members in loan repayment and inability of societies to raise resources, (ii) inability of the members to provide the prescribed security, (iii) lack of up-to-date land records or inalienable rights to land or inability to produce sureties, (iv) ineligibility of certain purposes for loans, (v) inadequacy of credit limits prescribed, and (vi) onerous conditions prescribed such as share capital contribution at 10 or 20 per cent of loans outstanding and compulsory thrift deposits.

The PACS are passing through a long phase of re-organization which was formally started in early 1960's, following the recommendation of the Committee on Co-operative Credit (1960). But its progress to date has been very slow. Currently the reorganization work is running along the following lines : (a) the PACS are being reorganized so that every reorganized PACS covers a gross cropped area of 2000 hectares within a radius of 10 kms.: (b) Non-viable units are either amalgamated with reorganized societies or liquidated. But compulsory amalgamation/liquidation is not easy, as it often meets with stiff resistance from local beneficiaries and functionaries and the state governments have hesitated using compulsion in the matter; and (c) the setting up of new types of societies called Farmers Service Societies (FSS) and Large-Sized Multi-Purpose Societies (LAMPS) for tribal and hill areas. The FSS,

that are being organized since August 1975, are intended to cater particularly to the credit needs of the weaker sections and provide integrated credit supplies, services and technical guidance to the farmers at one contact point.

In the organization of these societies preference is being given to districts covered by special development programmes, such as 'Small Farmers Development Agency (SFDA), Command Area Development Programme (CADP), 'Drought Prone Areas Programme' (DPAP), etc. LAMPS are being organized in tribal and hill areas somewhat on the lines of FSS for providing all types of credit' viz., short term, medium and long-term including that for meeting the social needs, agricultural and consumers requisite, technical guidance in the intensification and modernisation of agriculture and arranging for the marketing of agricultural and minor forest produce. Both FSS and LAMPS are linked for financial-accommodation either to a central co-operative bank or a commercial bank. Their progress is understandably slow because of the difficulties in meeting certain essential prerequisites to the success of the new programme, viz., liquidation or amalgamation of other existing non-viable societies in the areas of FSS and LAMPS so as to provide the new units an exclusive area of operation, as also the provision of managerial and technical staff for them.

Since June 2009 the commercial banks have also been associated by the RBI in the rehabilitation of weak PACS. Under the RBI's scheme, commercial banks take over societies for giving them short and medium term loans, Both the number of societies and the amounts involved so far are small .

2. *Inadequate Resources* : The resources of the PACS are much too inadequate in relation to the short and medium term credit needs of the rural economy. The bulk of even these inadequate funds came from higher financing agencies and not through owned funds of societies or deposit mobilisation by them. The resource mobilisation capacity of the PACS will improve substantially, if through reorganization and related measures, they are converted into strong and viable units. Then, they should be able to attract both more deposits and more loans from higher financing agencies.

3. *Over Dues* : Large over dues (of more than 40 per cent of demand and of credit outstanding) have become a big problem for the PACS. They check the circulation of loan-able funds, reduce the borrowing as well as lending power of societies, and give them the bad image of the societies of defaulting debtors. The RBI data for various years show that the percentage of over dues is much higher for landowners; among landowners, the percentage of over-dues might be willful and that bigger landowners take undue advantage of their relatively stronger position in villages in both appropriating cheaper co-operative credit and not paying back their loans in time. In years of poor crops due to bad weather conditions, some over dues in the areas of heavy crop failures are understandable. But year after year upward of 40 per cent of loans outstanding being overdue cannot be so justified. And this is after some unknown portion of loans issued during a year are simply renewals of loans overdue. The over dues position is not uniform across the states. It has been particularly bad in Bihar, Assam, and Madhya Pradesh.

According to the Banking Commission in most states, over dues are due to (a) indifferent management or mismanagement of societies; (b) unsound lending policies leading to over financing, or financing unrelated to actual needs, diversion of loans for other purposes; (c) vested interests and group politics in societies and willful defaults; (d) lack of adequate supervision over the use of loans by the borrowers and poor recovery effort; (e) lack of adequate control of banks (CCBs) over the primary societies; (f) lack of appropriate link between credit and marketing institutions; (g) failure to take prompt action against willful defaulters; and (h) uncertain agricultural prices. These factors still hold good.

4. *Inadequate and Restricted Credit* : Co-operative credit is inadequate in several senses. First, the PACS provide credit to only a small proportion of the total rural population, Second the societies do not provide full credit even for all productive agricultural activities. The credit given is confined mainly to crop finance (seasonal agricultural operations) and medium-term loans for identifiable purposes such as digging of wells, installation of pump sets, etc. Most of the societies do not provide credit for other

productive activities undertaken by the agriculturists. Even for approved productive activities, the credit given is usually not adequate to meet in full the need for credit. In most cases, non-agricultural credit needs even for productive purposes are not met at all. Consumption loans are generally not given.

What is required is to improve the effective coverage of societies by providing credit to increasing proportion of rural households, especially of weaker sections, to widen the range of eligible purposes for which credit is given, and then to meet an approved borrower's entire credit needs. To realize this objective in practice, the societies must be made organizationally as well as financially strong along the lines already suggested above.

5. *Other Linked Inputs, Extension Service, and Marketing :*
The provision of adequate and timely credit is only one of the necessary conditions for improving the productivity of farmers and others in villages. Additional facilities in the form of the supply of inputs (like better seeds, fertilizers, pesticides, etc.) extension and marketing service must also be provided to small and marginal farmers to enable them to make good use of the credit given to them. Already a step in this direction has been taken in the form of Farmers Service Societies (FSS) for small and marginal farmers. But what is required is not proliferation of new (forms of) societies, as of revitalizing weaker societies into stronger units, most possibly by reorganizing them into larger sized multi-purpose co-operatives .

Primary Co-operative Banks (PCBs) :

A large number and variety of primary non-agricultural credit societies have also been organized. Of these, PCBs are the most important. At the end of June 2009, they were more than 1,300 in number. Of them, more than 1,200 were 'urban co-operative banks', the rest were 'salary earners societies'. The development of the PCBs is looked after by the RBI, as they operate only in urban and semi-urban areas and so are not a charge on the NABARD.

The working capital of these banks is drawn largely from public deposits (from members and non-members) and to a relatively smaller extent from owned funds and borrowings. Both the RBI

and the IDBI offered them concessional refinance facility on a selected basis. These banks provide housing finance and loans and advances for various other purposes such as petty trade and industry. At the end of June 2009, they had loans outstanding of more than Rs. 2,500 crores.

These banks are doing useful work in mobilising deposits and financing small borrowers. They deserve to be encouraged in all possible ways, as there is both need and potential for them in both the spheres of deposit mobilisation and the provision of credit to small borrowers through them. Large national banks have a tendency to prefer large to small borrowers. Small urban banks, with the area of operation of any bank restricted to a town or a part of a major city, on the other hand, have an opposite bias in favour of small borrowers and small individual loans. Therefore, for credit to small borrowers, special efforts should be made to encourage them.

RBI/NABARD and' Co-operative Banking System :

Though the co-operative credit movement was made a special responsibility of the RBI right from the-latter's birth in 1935, much was not accomplished in this sphere till about the mid 1950s. The real turning point in the Bank's role in the movement came only after the Bank's All India Rural Credit Survey Committee submitted its monumental report in 1954. The Survey Committee had found that while the co-operative societies , and government provided only 5% each of the loans raised by the cultivator, the private credit agencies (the moneylender and the trader) lent more than 70% of what the cultivator borrowed. The moneylender charged very high rates of interest and did not concern himself with the purpose of the loan. The Survey Committee summed up the position of agricultural credit thus. It fell short of the right quantity, was not of the right type, did not serve the right purpose and often failed to go to the right people. It also said that co-operation had failed but co-operation must succeed'. For this success, the Surve'y Committee recommended an 'integrated scheme of rural credit, of which the important features were :

- (i) state partnership in co-operative credit institutions through contribution to their share capital;

- (ii) full co-ordination between credit and other economic activities especially marketing and processing; and
- (iii) administration through adequately trained and efficient personnel, responsive to the needs of the rural population.

The RBI was assigned a crucial role in the scheme of integrated credit and in the building up of the cooperative credit organization. The consequent steps taken by the RBI in pursuance of the recommendations of the Survey Committee and later committees like the Committee on Cooperative Credit (1960) transformed the Bank's role from that of a conventional central banker to that of an active agency that takes all necessary measures for enabling the co-operative system to provide a glowingly larger share of rural credit. The adoption of special programmes for increasing agricultural production and the spread of green revolution based largely on intensive use of fertilizers, water, better seeds, and machine power have enhanced the RBI's responsibilities further. The RBI had also started offering greater financial assistance to co-operatives for credit facilities to small farmers and other weaker sections and for Minimising disparities in the flow of credit to various regions.

With the setting up of the National Bank for Agriculture and Rural Development (NABARD,) in July 1982 the RBI's functions relating to the co-operative movement have been taken over by the NABARD. Now, the RBI's role is primarily restricted to the provision of finance to the NABARD through its contributions to the two national rural credit funds already transferred to the NABARD, and additional loans and advances to the latter. Besides, the RBI still offers loans and advances to SCBs.

The NABARD measures are basically a continuation of the RBI measures. They are studied below under two main heads (A) provision of finance, and (b) building up of the co-operative credit structure.

(A) Provision of Finance : All the NABARD finance is provided to the co-operative sector through the SCBs. The bulk (almost 90%) of it goes to finance agriculture. The finance is of all the three types, viz., short-term, medium-term, and long-term.

(i) *Short-term Agricultural Finance* : This is given primarily for seasonal agricultural operations which is interpreted to include mixed farming activities, i.e., animal husbandry and allied activities jointly undertaken with agricultural operations.

(ii) *Medium-term Agricultural Finance* : The NABARD provides medium-term loans to SCBs for periods of 3 to 5 years. These loans are given for : (a) agricultural purposes (purchase of agricultural machinery, sinking and repair of wells and tube wells, etc.), animal husbandry, poultry farming and for purchase of shares of co-operative sugar factories and other processing societies by agriculturists, and (b) conversion of short-term agricultural loans into medium term loans whenever such conversion becomes necessary on account of wide-spread crop failure as a result of drought, floods or other natural calamities. All medium-term loans are fully guaranteed as to the repayment of the principal and the payment of interest by the state government concerned.

(iii) *Long-term Agricultural Credit* : Long-term credit for agriculture is provided mainly through investment in the debentures of SLDBs. In addition, the National Bank makes long-term loans to state governments for contribution to the share capital of co-operative credit institutions, most of which goes to strengthen co-operative credit for agriculture.

The financial accommodation of all kinds indicated above is provided at concessional rates of interest which vary between the Bank Rate and up to 3% below the Bank Rate.

(iv) *Non-agricultural finance* : The NABARD also provides short-term finance for (i) the production and marketing activities of selected cottage and small-scale industries (mostly handloom weavers co-operative societies) and (ii) the purchase and distribution of fertilizers. The loans are generally provided through SCBs against guarantees of the state governments. However, all such finance has constituted a small proportion (5 to 7 per cent) of the total Reserve Bank short-term finance to co-operatives : the bulk of it goes to agricultural co-operatives.

During 2008-2009, the NABARD credit had amounted to about Rs. 2,300 crores, of which about Rs. 2,200 crores (or the

overwhelming proportion of the total) were short-term credit. Besides, NABARD had disbursed about Rs. 1,200 crores of long-term refinance assistance under various schemes about 30% of which was routed through the SLDBs and the SCBs.

(B) Building up of the Co-operative Credit Structure From around 1951 the RBI made efforts to (a) strong- then the co-operative credit structure at all the three levels, and (b) reorient the operational policies of cooperative banks in more propulsive directions. Under the former, the RBI had taken steps to get SCBs established in such states that did not have, them and strengthen them where they were weak. The RBI had also tried for the rehabilitation of weak CCBs by prescribing action to recover over dues, strengthen the bad debts reserves and improve the quality of the administrative and supervisory staff. Similarly, the Bank played an active role in the reorganization of primary societies. The bank had also made arrangements for the training of personnel co-operative departments and institutions and undertaken periodical inspection of SCBs, CCBs, and SLDBs to promote healthy and sound growth of co-operative banking in the country. All these functions are now being performed by the NABARD.



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