

A RESERVE BANK FOR INDIA AND THE MONEY MARKET

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CALCUTTA:

BUTTERWORTH & CO. (INDIA), LTD., 6, HASTINGS STREET.

MADRAS BRANCH: 317, LINGA CHETTY STREET.

BOMBAY BRANCH: JEHANGIR WADIA BUILDING, ESPLANADE ROAD.

LONDON:

BUTTERWORTH & CO., (Publishers) LTD,
BELL YARD, TEMPLE BAR.

TORONTO (Canada):

BUTTERWORTH & CO.,
(Publishers), LTD.

SYDNEY:

BUTTERWORTH & CO.,
(Australia), LTD.

WELLINGTON (N. Z.):

BUTTERWORTH & CO.,
(Australia), LTD.

1931

PRINTED AT THE
BASEL MISSION PRESS MANGALORE

PREFACE

A reproach is on us. India, we are told, is one of the very few countries which have not yet mobilized their banking under the shadow of a Reserve Bank. This book is an attempt to show why the reproach is to be borne by us, and how it could be shaken off. An effort was made a few years ago to establish a Reserve Bank in India, but was allowed to die out. It is to be revived again and, to base it on a solid foundation, various Banking Enquiry Committees have been instituted by the Government in the Provinces so that not merely will the defects of the dismembered banking structure of India be detected but the real brick and mortar needed to construct the Reserve Bank may be prepared.

To the majority of people the subject of Reserve Banking (or Central Banking) appears too technical and complicated a matter to awaken a desire for its comprehension. This book is an attempt to set forth for the *general reader* in *non-technical* language, except where technicalities are unavoidable, *the fundamental principles and actual working of a Central Bank and also what the Bank should be in the case of India*. Its design is, therefore, twofold : (1) It explains how in actual practice a Reserve Bank performs its functions and what benefits accrue therefrom. In explaining them, the help of simple diagrams has been found necessary, however much their inclusion may expose one to the charge of using the class-room method, which is but natural to the writer. This is particularly the case on the subject of "A Bill Market for India". (2) It also considers the factors special to India and the kind of structure that should be superimposed on the banking

system of India. This latter part is an attempt to show how near it should be to the ideal of an American critic who said, "The Central Bank that India needs must be *sui generis* ; it must be as Indian as the Ganges".

The subject-matter is developed step by step and the chapters are closely inter-related. Any attempt, therefore, to pick out a Chapter independently for perusal and to form one's judgment on it, would be doing injustice to the book.

Although the system of note issue for India is discussed at length, the standard of currency dealt with is the same as recommended by the Royal Commission on Currency and Finance (1926). Whether India requires a gold currency for her economic greatness and whether it could be established successfully, should also have been discussed from the practical point of view. But in order to keep strictly to the principal object of this book and to avoid making it cumbrous (as the matter might probably take up a volume by itself) the subject is left to be dealt with separately.

The sources of the book, a list of which is appended, include in particular a huge list of Memoranda submitted by the various business and banking institutions and authorities on banking in India on the Reserve Bank of India Bill. In the collection of these, the writer's special thanks are due to the Secretary of the Indian Merchants' Chamber, Bombay. The information regarding many Central Banks was received either directly by correspondence with the authorities or through the Consuls for certain countries in India. The writer owes a personal debt to all these gentlemen and, in particular, to the Governor and Secretary of the Commonwealth Bank of Australia, the

Consul-Governor for Germany, the American Consul, the Consul for Japan, the Consul-General for Belgium, the Consul for Czechoslovakia, the Consul for the Netherlands, the Consul-General for Italy and the French Trade Commissioner in India, Burma and Ceylon. Acknowledgment of indebtedness is also made to the Manager of the Bombay Provincial Co-operative Bank for the information concerning agricultural finance in India. The help which was given by three students, Messrs. J. A. Hus-sain, V. V. Prayagi and R. W. Ghate in preparing diagrams cannot but be acknowledged gratefully by the writer.

Nagpur :
March 7th, 1930.

B. E. D.

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of the Indian Central Cotton Committee on Eight Investigations into the Finance and Marketing of Cultivator's Cotton; The Indian Year Book; The Indian Quarterly Register; Reports of the Annual Meetings of the various Chambers of Commerce, Indian and European, 1927-28; Report of the External Capital Committee; The Investor's India Year Book.

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EXPLANATION OF FIGURES

As a guide to the reading of the figures it may be mentioned that :—

100,000 rupees = 1 *Lakh* rupees = £ 7,500.
(at the present rate of exchange.)

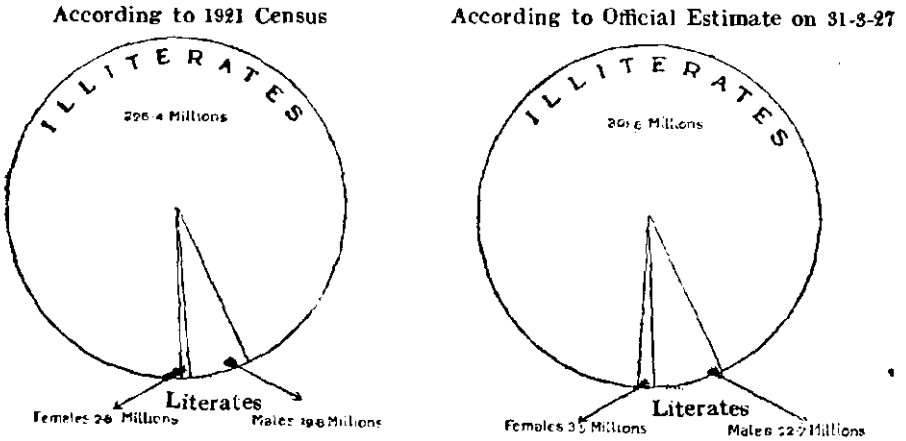
100 lakhs (10 million rupees) = 1 *Crore* rupees = £ 750,000.
(at the present rate of exchange.)

CHAPTER I

SOME IMPORTANT STATISTICS RELATING TO INDIA

In the institution of any new economic machinery in India predominance must be given to two important statistical data which must always form the basis for careful consideration, namely, those concerning (1) illiteracy and (2) the agricultural economy of the country.

I. ILLITERACY :—The following diagrams show what immense numbers of the people are illiterate.



Estimated illiteracy in India as at 31st March 1927 as compared with the same in 1921.

According to the Census of 1921 out of the total of 319 millions, 296.4 millions were illiterate, whereas the official estimate of the total number on the 31st March, 1927 was 328 millions of which 301.8 millions were illiterate.

II. POPULATION :—The principal occupation of the people in India is agriculture. The latest estimate of the percentage of the total population which is engaged in agriculture and pastoral pursuits is still very near 73.9 per cent., those engaged in industries is nearly 11 per

cent. (.5 per cent. increase over the Census of 1921) and those in trade nearly 6 per cent. (.3 per cent. increase over Census of 1921).

Of the total population nearly 89 per cent. live in villages and 11 per cent. in towns (.8 per cent. increase over Census of 1921).

III. THE INDIAN CURRENCY SYSTEM :—

The Indian Currency at present consists of *two kinds of tokens* :—(1) the *silver rupee* coin (180 grains in weight and 11/12th fine), and (2) Government paper notes in the form of a promise by the Government of India to pay on demand a specified number of rupees. The paper notes and the silver rupees are mutually convertible. For the purpose of maintaining the value of the token currency the Government of India holds *two reserves* (i) the Paper Currency Reserve and (ii) the Gold Standard Reserve. The former is held as a backing against the notes in circulation, and is composed of the proceeds of the note issue, whereas the latter is made up of the profits on the coinage of silver rupees and is designed chiefly to maintain the external value of the coins.

The Standard of Currency existing at present is what is usually called the '*Gold Exchange Standard*', but the Royal Commission on Indian Currency and Finance, 1926, declared that "in truth in so far as it amounted to a definite standard at all, it was a standard of *sterling exchange*." It is *managed* by the Government who, by the buying and selling of official bills try to control the standard. The fundamental defects of this standard have been shown by the Royal Commissioners who have consequently condemned it.

THE RATE OF EXCHANGE :—By the new Currency Act, No. 4 of 1927 the rupee is declared to be

worth 1s.-6d. gold, (equivalent to 8.47512 grains of gold), its fluctuations being confined between the upper and the lower gold points corresponding to that ratio.

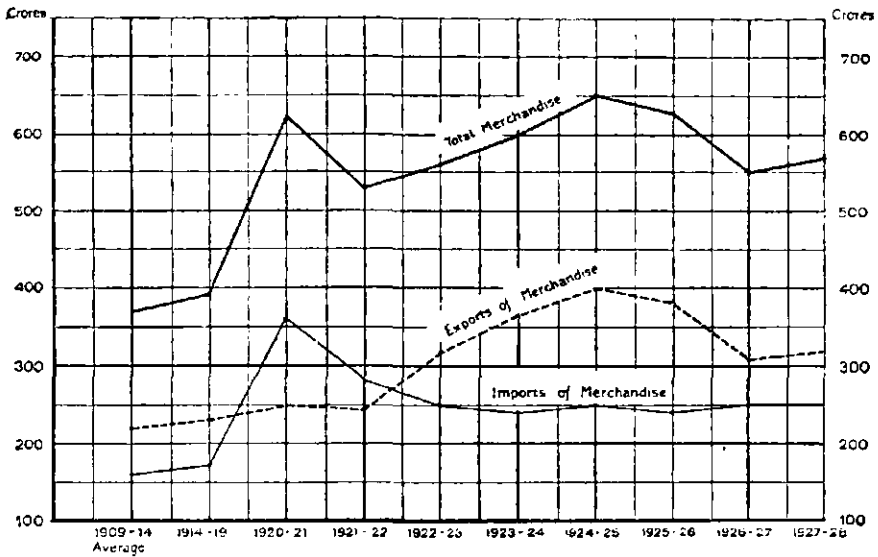
IV. HOME PRODUCTION :—No official survey has yet been attempted regarding the valuation of different kinds of production in India, in order to arrive at the figures for the annual wealth of India. But two Indian economists, Messrs. Shah and Khambata, have made a very useful estimate of the total wealth of India for 1921-22, which is given in the following table :—

| Production | Value (in Crores of Rupees) |
|---|--------------------------------|
| 1. Agriculture (Net) | 2097.8 |
| 2. Industries ¹ | 150 |
| 3. Handicrafts and Cottage Industries | 40 |
| 4. Minerals | 29 |
| 5. Forests | 28 |
| 6. Building Operations | 20 |
| 7. Fisheries | 3.2 |
| <i>Total</i> | 2368 |

V. INTERNAL AND FOREIGN TRADE :—

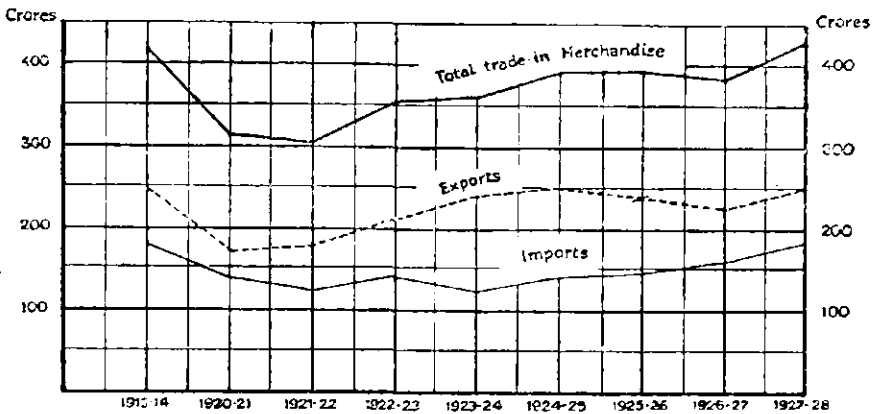
The value of India's sea-borne trade and its progress during nearly a decade as compared with pre-War and War averages have been shown in the following diagram.

¹ (The Production from Industries was valued by Messrs. Shah and Khambata at Rs. 146 Crores. But on the same estimate the present production is nearly Rs. 150 Crores).



The Foreign Sea-borne Trade of British India and its progress during 1920-21 to 1927-28 as compared with pre-War and War averages.

The above diagram also illustrates the fact that normally the Balance of Trade is in favour of India. But to arrive at a fairly accurate knowledge of the *course of Indian trade* the value of the exports and imports of mer-



The Course of Indian Trade during 1920-21 to 1927-28 determined on the basis of the declared value in 1913-14.

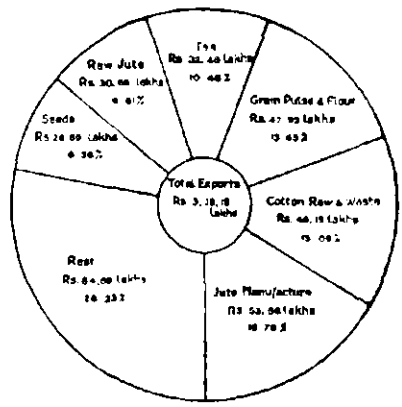
chandise for the last eight years has been determined on the basis of the declared value in 1913-14 and the figures arrived at are shown in the above diagram. ¹

¹ The figures are taken from the Indian Year Book, (Times of India)—1929.

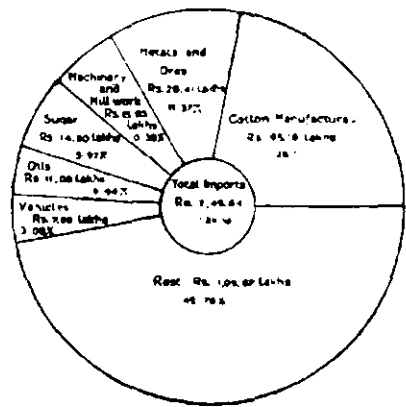
The diagram reveals the fact that when the valuation of the pre-War year is taken as the basis, the imports have a tendency to rise from 1923-24 onwards, although the surplus of exports over imports is so far assured.

Another principal feature of India's sea-borne trade is that exports are mainly of produce and imports of manufactured goods. This is illustrated in the following diagram. The figures relate to 1927-28.

Exports of Merchandise



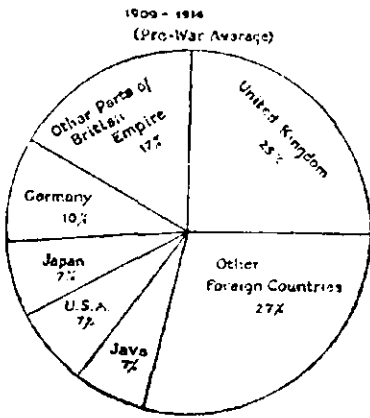
Imports of Merchandise



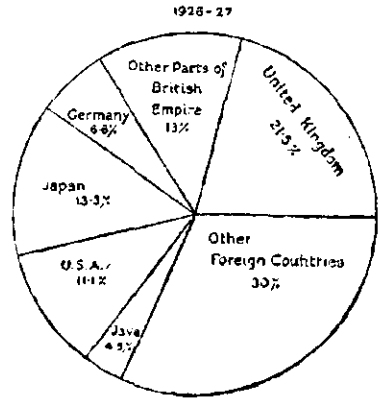
Exports and Imports of Indian Merchandise during 1927-28, and comparative importance of principal articles exported and imported.

The diagram also shows the comparative importance of the principal articles exported and imported. On the import side, as usual, cotton manufactures were by far the most important item, and on the export side, jute manufactures, as usual, scored the first place.

It is also important to know the *direction* of India's trade. In examining it a comparison is made between the pre-War average and the year 1926-27.



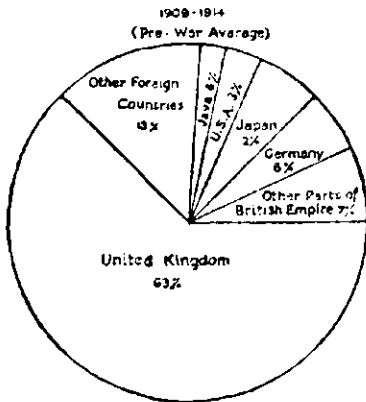
Export :



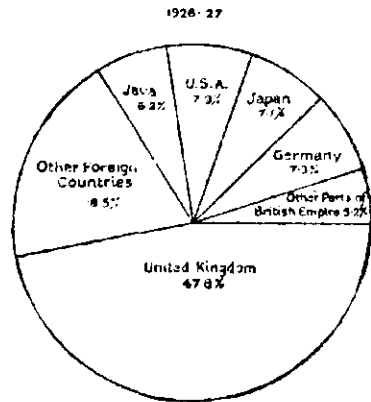
Direction of Indian Trade during 1926-27 as compared with pre-War average of 1909-1914 Exports.

The above diagram shows that the United Kingdom has the largest share of India's exports but that share has decreased, whereas the share of Japan and the United States of America has increased substantially.

But the diagram given below shows that not only is the share of the United Kingdom in India's imports predominantly the largest but that it has fallen heavily as



Imports

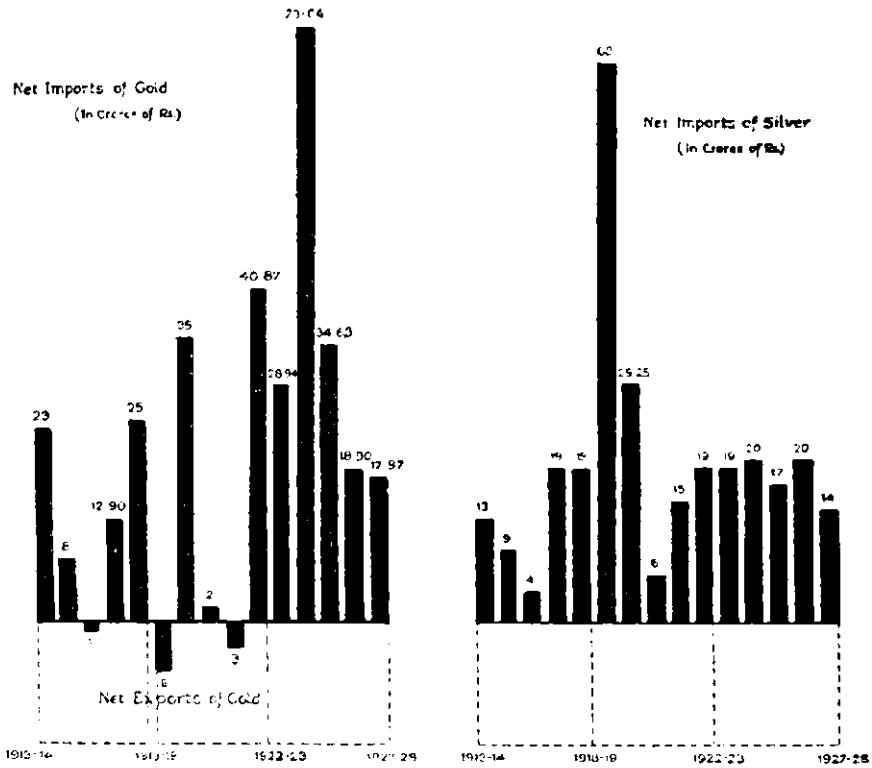


Direction of Indian Trade during 1926-27 as compared with pre-War average of 1909-1914 Imports.

compared with the pre-War average. The share of Japan and the United States of America shows a noteworthy increase from 2 per cent. to 7.1 per cent. and from 3 per cent. to 7.9 per cent. respectively.

There are no official statistical data regarding the *internal* trade of India, but various economists have estimated it to be not less than *fifteen times* that of India's foreign trade. Taking the average of the value of foreign trade at Rs. 600 crores, the total volume of internal trade would be Rs. 9,000 crores.

VI. IMPORTS AND EXPORTS OF GOLD AND SILVER :—As a result of the Balance of Trade normally in favour of India there have been large net imports of



Value of India's imports and exports of gold and silver, both coin and bullion during each year from 1918-19 to 1927-28 as compared with 1913-14. gold and silver (coins and bullion) into the country. The extent of these net imports is shown in the above diagram. It is of special interest to note that the percentage of India's imports of gold to world production of gold for the ten years ending 1928-29 has been estimated to average 22 per cent., and that in 1924 the net imports of gold were

two-thirds of the world production in that year.¹ Since gold is *not* functioning as currency in India which has a *token silver* currency, it is natural that encouragement is given to the people to hoard gold, as it is the best store of value.

VII. *BANKS IN INDIA* :—(a) *Classes* :—The Banks in India are classified as follows :—

- (1) *The Imperial Bank of India* :—A private Joint-Stock Company under Government control. It performs one or two functions of a Central Bank at present and was established at the end of 1920 as a result of the amalgamation of the Presidency Banks of Bombay, Calcutta and Madras.
- (2) *Exchange Banks* :—These are branch agencies of foreign banks whose head offices are outside India. Their main function is dealing in foreign exchange.
- (3) *The Indian Joint Stock Banks* :—registered under the Indian Companies Act.
- (4) *The Indian Co-operative Banks* :—registered under the Co-operative Societies' Act II of 1912.
- (5) *The Savings Banks*.
- (6) *The Shroffs* or Indian private bankers.

In this Chapter Statistics of the first three classes of banks only are given, the others being treated separately.

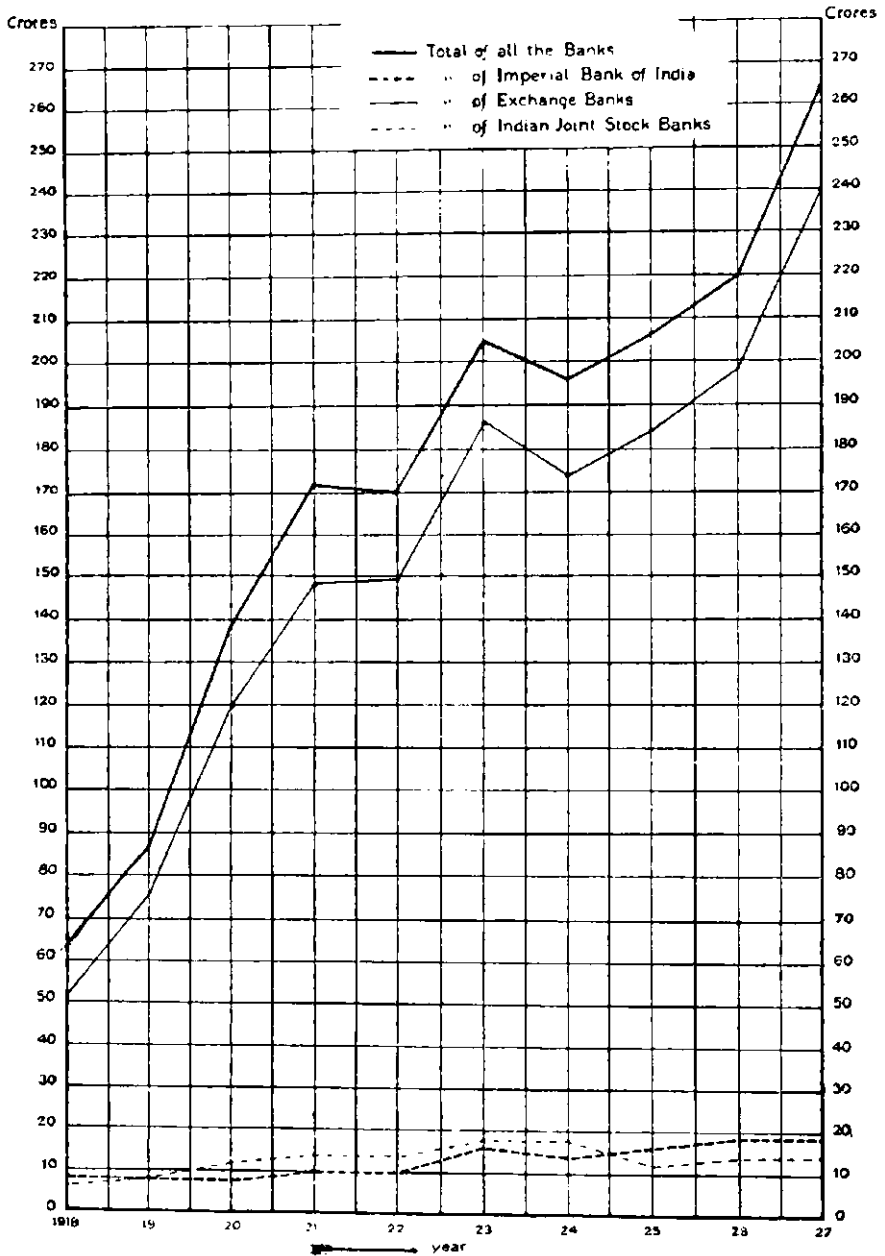
The number of head offices and branches of banks, including agencies, in 1927 was as follows :—

(b) *Number of Banks* :—

| CLASS | Head Offices | Branches |
|---------------------------------------|--------------|----------|
| 1. Imperial Bank of India | 3 | 165 |
| 2. Exchange Banks | — | 88 |
| 3. Indian Joint Stock Banks | 122 | 406 |

¹ The estimate is made by Mr. G. Findlay Shirras, Ex-Director of Statistics with the Government of India, *Economic Journal*, December—1929.

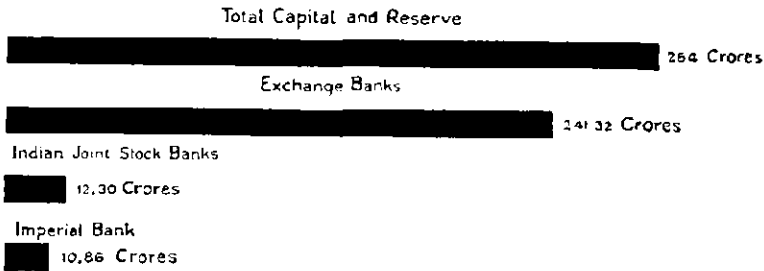
(c) *Total Capital and reserve* :—The progressive total of the capital and reserves of the three classes of banks during the last ten years is shown in the following diagram



Progressive total of Capital and Reserves of Banks in India during 1918-19 to 1927-28. Capital and Reserves.

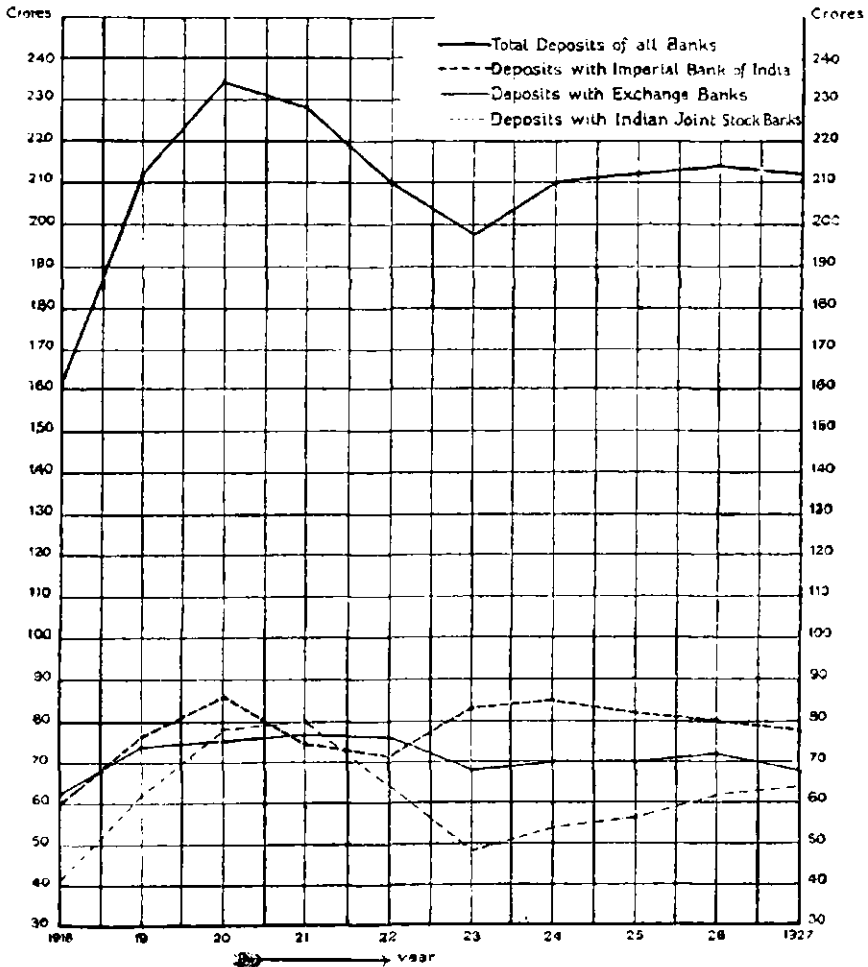
which clearly proves that the total of the foreign banks completely eclipses that of all Indian banks.

The relative position of their capital and reserves in 1927 is made clear by the following diagram :—



Relative position of Capital and Reserves of the Banks in India in 1927 .

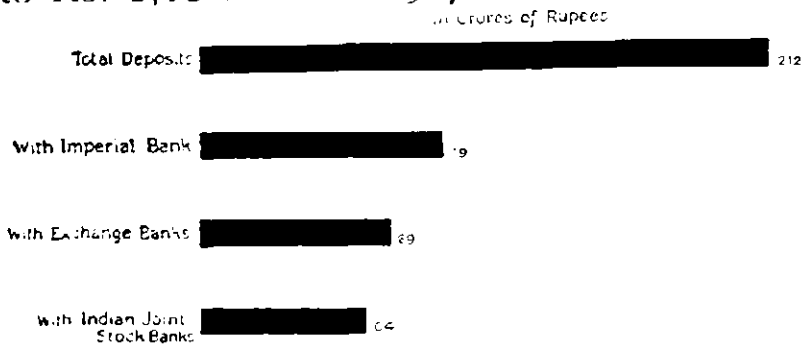
(d) *Total deposits* :—The growth of bank deposits during the last decade is illustrated in the following diagram.



Growth of Bank deposits in India during 1918-19 to 1927-28.

12 A RESERVE BANK FOR INDIA AND THE MONEY MARKET

It would appear from it that the total deposits in all the three classes of banks increased from Rs. 1,64 crores in 1918 to Rs. 2,12 crores in 1927.

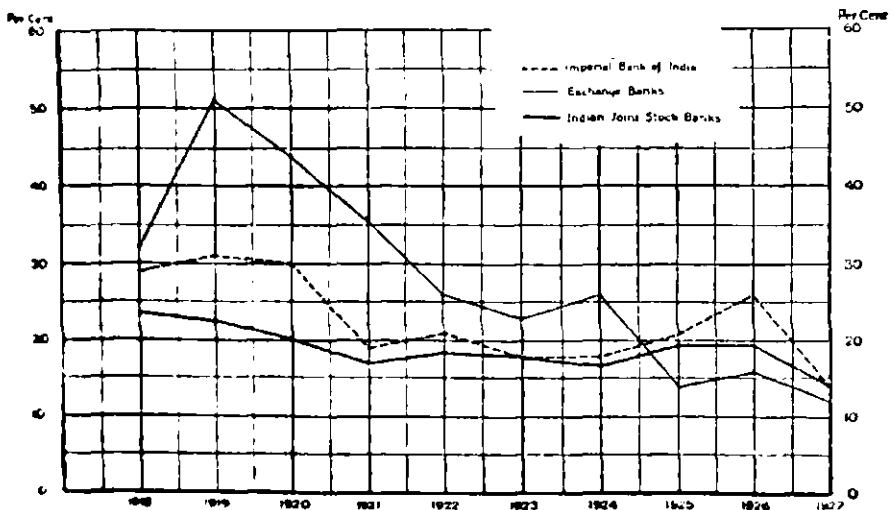


The respective shares of the banks in total deposits in 1927.

The respective shares of the three classes of banks in the total deposits in 1927 are shown in the above diagram.

Thus, the shares were : Imperial Bank of India 37 per cent., Exchange Banks 33 per cent., and Indian Joint Stock Banks 30 per cent.

(e) *Proportion of cash to deposits* :—The proportion per cent. of cash to liabilities on deposits of the three classes of banks (on 31st December each year) during the ten years ending in 1927, is shown in the diagram given below :—



Proportion per cent. of Cash to Liabilities on Deposits of Banks on 31st of December of each year.

It will be seen that at the end of 1927 the cash balances were 14 per cent. in the case of the Imperial Bank of India, 14 per cent. in the case of Indian Joint-Stock Banks (averaged for all banks) and $12\frac{1}{2}$ per cent. in the case of Exchange Banks (averaged for all banks) whose deposits in India only are considered.

(Other Statistical Data are included in the various Chapters.)

VIII. A FEW COMPARISONS :—In the following Table Indian Banking Statistics have been compared with those in other countries.

| Country | BANKS (Total number) | Banking Capital and Reserves (£ millions) | Deposits of Banks (£ millions) |
|--------------------------|----------------------------|--|--------------------------------------|
| United States of America | 30,100 | 1052 | 8000 |
| United Kingdom . . . | 9,550 | 180 | 2225 |
| Japan | 5,900 | 110 | 410 |
| Canada | 3,450 | 25 | 450 |
| Australia | 2,500 | 59 | 374 |
| India | 659 | 17* | 163 |

* Excluding those of the Exchange Banks.

The following Table gives a comparison of population per bank, square miles served per bank and deposits per individual in India with other countries.

| Country | Persons per Bank | Square Miles per Bank | Deposits per individual (£) |
|--------------------------|---------------------|--------------------------|-----------------------------------|
| United States of America | 3056 | 118 | 86 |
| United Kingdom . . . | 4816 | 11 | 48 |
| Japan | 9491 | 23 | 7 |
| Canada | 1391 | 1044 | 93 |
| Australia | 1800 | 1170 | 83 |
| India | 4,84,066 | 2735 | 0-10s.-2d. |

CHAPTER II

CO-ORDINATION OF CREDIT AND CURRENCY

IMPORTANCE OF CO-ORDINATING CREDIT AND CURRENCY :—When asked by a shareholder of a bank at its general meeting to explain the reasons for giving extensive loans the Chairman said : “No credit, no production ; no production, no banking !” Although there is some exaggeration in this statement, there is much truth in it. It emphasizes the fact that the amount of production and business which flourish on credit in modern times is colossal. The producer needs the use of money in the different stages of production. In the initial stage of the establishment of the organization he needs an *advance* of money ; after the organization is complete, he begins to produce goods in *anticipation* of a demand for them. He must, therefore, buy his raw materials, pay wages and salaries to his workmen and staff, and incur other expenses before his goods are actually sold. The real function of the bank is to assist him to secure an advance of funds for all these purposes. The same is true of the commercial man. He buys a commodity from one person and sells it to another generally on credit ; but initially he needs funds to buy it and finds in a bank the agency for meeting his needs.

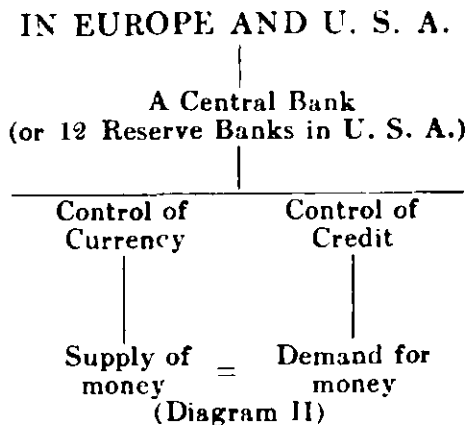
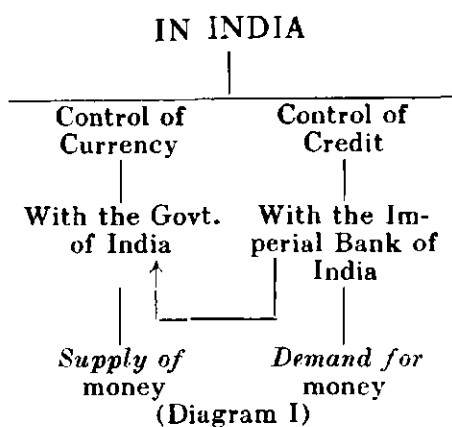
The volume of production and business and the amount of banking credits are generally related. If production increases and business becomes active there is greater demand for credit, more bills are created and the banks

have to prepare themselves with more ready capital to be loaned to their customers. If, however, production diminishes, there is less demand for credit and fewer bills are presented at the banks. It is true that there is also what is called purely personal credit, which does *not* depend upon goods. But such credit is comparatively rare and is tendered more for consumption than for production. But when credit is extended by the banks, it takes the form of currency whether *metallic* or *paper*. A banker is principally a dealer in *money* and his bank is the reservoir of such money as he has borrowed in the form of deposits. It is *money* which is the basis of all business which he transacts and all the operations which he undertakes. When he extends his credit in the form of promises to pay to borrowers, these promises have behind them *money* for which they will be exchanged and that is why they pass freely from hand to hand. When he accepts cheques, bills of exchange or drafts, it is because they are drawn by persons having money or power to obtain it and can be converted into money without incurring loss. In its *ultimate analysis* a credit instrument is money which the banker either promises to pay on demand or receives from his customers.

Hence arises the direct relation between credit and currency. The amount of credit to be extended in a country depends not merely on the demand for it, but substantially on the amount of currency on hand in the banks. If the supply of money with the banks was not sufficient to meet the demand for it, credit would have to be curtailed, and to that extent the position of the producers and businessmen would be made difficult. Their activities in turn would have to be curtailed, and the country as a whole, would suffer. To the extent, therefore, that the produc-

tion of goods and the activity of trade depend on the credit policy of the banks, and the credit policy depends on the supply of currency available at the banks, it follows as a natural consequence that *credit and currency should be co-ordinated*. Those who control the credit must also be given the control of currency. Then alone will the supply of currency adjust itself adequately to the demand for it.

This point can well be emphasized if conditions in India are compared with those in the U. S. A. and Europe.



The above diagrams are sketched to explain the main differences existing in the adjustment of the demand and supply of money in India and in Europe or the United States of America.

In the latter countries (as in diagram—II) there is a unified control of credit and currency in the hands of a Central Bank (or 12 Reserve Banks as in the case of the U. S. A.) and the result is obvious—the supply of money adjusts itself adequately to the demand. But in the case of India (as in diagram—I) the position is different. The Government of India controls the currency, but the Imperial Bank of India controls the credit. This results

in *divided control* which in its turn results in the *inadequacy* of the supply of currency to meet the demand.

The conclusion, therefore, becomes inevitable that with the growth in India's business and trade, if the needs of the community are to be well supplied, the control of both currency and credit should be in the hands of a *single authority* i. e., a *Central Bank* established in the country.

If credit and currency are to be unified, it follows that note issue should be the proper function of a Central Bank. This function is also concentrated *for other great benefits* which accrue to a country. But before we deal with them, it is necessary to understand the relative merits and demerits of note issue by the Government and by a Central Bank.

PART I.

Government *versus* Bank Note Issue.

In the first place, a Government cannot possess an accurate knowledge of the demand for currency by the commerce and industry of a country, because, not being engaged in banking, it cannot come into direct contact with them. It is a body located far from them and it can know their demand only through the instrumentality of the banks of the country. A Government cannot, therefore, adjust the supply of currency to meet unforeseen demands. And as the needs vary every day and in different proportions, it becomes increasingly difficult for a Government to bring about the necessary adjustment, since "it is not as sensitive as a bank to the conditions in the financial and commercial world."¹ But this inability is bound to become acute in an emergency when businessmen have very urgent need of cash, be-

¹ Kisch and Elkin: The Central Banks, Page 73.

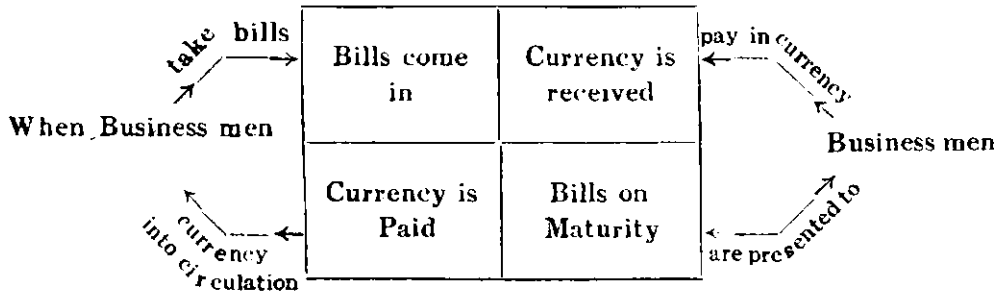
cause the Government mechanism is a slow but cautious process and is not readily responsive to sudden changes. A Government whose primary duty is to look to the security of the currency system is naturally forced to study the problem that arises patiently and thoroughly, with the result that some time elapses before any action is taken and the emergency demand may go unsatisfied. It may, therefore, happen that at times the supply of currency is less than its demand, viz., there is stringency of money, or that the supply exceeds the demand, viz., there is over-issue of money.

But the case of a bank issue is different. A bank note fulfils the chief object of keeping the volume of currency constantly adjusted to the requirements of production and trade because its issue is *directly based on business transactions*. If banking business is legitimate, the issue of bank notes is *the result of extending credit*. If credit is judiciously given, bank notes will go into circulation when business men need them, and return to the bank when their need is over.

The relation between the mechanism of the discount of bills of exchange and the issue of notes by a bank will tend to emphasize this. Suppose at a particular time, say in July, business men are in need of Rs. 1 crore and that in order to secure a loan of this amount they take their bills of exchange to be discounted at the bank. When that is done bank notes worth Rs. 1 crore would leave the bank, and enter into circulation. But when the bills get matured, say, in October, they would be presented to the debtors who would pay the bank in bank notes. Thus, Rs. 1 crore is withdrawn from circulation and returned to the bank. The operation, therefore, results in the *automatic adjustment* of supply of currency to the

real needs of business. When bills are discounted money enters into circulation, but when they are cashed on maturity, it is withdrawn from circulation.

BANK



∴ Expansion of Currency,

∴ Contraction of Currency.

If the number of business transactions is large, many bills of exchange are brought to the bank and the number of notes issued is large. On the contrary, in times of dull trade less bills are presented at the bank for discount and fewer notes are issued (Bankers' acceptance and elasticity of Bank paper are considered in other chapters).

The real danger involved in the issue of paper by a Government (either alone or in association with one or more banks) consists in the fact that "political considerations and the pecuniary needs of the State rather than considerations of a sound monetary economy are likely sooner or later to become the determining factor. There will be a risk of excessive issues and consequent depreciation."¹

Indeed, if a Government issued paper money on the solid security of gold in the reserve, this fear would not exist and convertibility of paper could be secured. But who is to be the compelling force? Exigencies of party politics, budget deficits and various other evils have led Governments to trespass on the legitimate bounds of paper issue, and the history of various countries lends

¹ Kisch and Elkin: Central Banks, Page 72.

support to this view. The intrinsic weakness lies in the fact that a Government is the ultimate controller of currency and that there is no other body directly above it to keep in check its manipulations.

And the danger of excessive issues with its resultant inconvertibility, becomes greater, because the modern financial system bases the expansion of credit on the fiduciary issue. There is, for instance, nothing to prevent a Government from *creating* securities and on their strength or backing issuing large quantities of paper-money.

These evils and dangers do not exist in the issue of paper by a Central Bank. Its issue is based on business principles. Political questions find no place in it. It is a non-political and independent body. The amount of its issue is regulated (a) by specific laws which compel it to keep a certain and definite proportion of gold or securities in its Reserve, and (b) by the necessity of the real trade needs of the country. Should, however, any injudicious step on the part of the banking authorities result in an excessive issue, matters are bound to be rectified. For there are, on the one hand, a host of businessmen to raise a vigorous protest against their action, and on the other, there is the controlling authority, the Government, to set it right immediately.

PART II.

A single bank of issue or competing banks?

If credit and currency are to be co-ordinated in order to make the supply of funds equal to the demand, the question arises whether it would be prudent to allow a single bank to have a monopoly of note issue or permit many banks to do so. Centralization of the right of note

issue in a single institution is absolutely necessary. When a single Bank has to perform the function of a sole controller of credit in a country it follows as a matter of course that, if its credit policy is to be made effective, it should have the sole monopoly of note issue. The credit structure which it can build up will depend on its control over the supply of currency, and if this control is split up among many issuing banks it would be impossible to mobilize currency. This centralized control over note issue is of immense value in times of bad trade when the Central Bank's power to help the money market is put to a severe test. Besides, with multiplicity of notes, there would be multiplicity of reserves, which in time of emergency would be impossible of mobilization.

In multiple note issues the danger of note issue is great. "The very independence of a bank with monopoly privileges", writes Dr. Jones, "removes from it all temptation such as might be presented in competition with rivals, to extend its issues beyond the limit of safety. As the struggle to earn dividends is absent the bank may order its policy to secure public welfare."¹ It is indeed impracticable to limit the dividends of commercial banks by legislation, and since issuing notes is a profitable business there is nothing to prevent the competing banks from reaching the maximum fiduciary limit prescribed by law in order to issue the largest amount of the notes and making the legal minimum the normal.² But it may come about that the maximum so issued is far greater than what is needed by the country. Besides, the effect of compe-

¹ Economic Crises, Page 111.

² 'No banks organized primarily for profit could afford to adopt a line of action which is so unprofitable from the point of view of dividends and which would place it at so great a disadvantage as compared with its competitors.'—Kisch and Elkin: Central Banks, Page 74.

tition among banks instituted for profits and trying to out-do one another to obtain trade, is to reduce the paper-money reserves below the limit of safety. Under the circumstances, if any unusual event makes the holders of notes rush to one of the issuing banks, it finds itself unable to meet the demand for redemption and "distrust spreads the demand to other banks in a similar condition, and the system, honeycombed by competition, falls into ruins. Suspension of banks, stringency of the money market, and a panic ending in a depreciated or worthless paper currency are the results."¹

Where there is a single issuing bank it is easy to locate responsibility in one centre and to conform to the fundamental principle of note issue that the institution issuing notes must also shoulder the responsibility of managing it successfully. "It puts an unmistakable duty upon those in whose hands the course of monetary affairs rests, and makes impossible the negligence and irresponsible venturesomeness observable with a multitude of competing banks."² With a multitude of banks there would be divided responsibility and divided management and it would be difficult for either a Government or the public to exercise control over them. A single note issue commands that prestige which has great influence on the psychology of business men during times of emergency. In emphasizing this point of special prestige Professor Charles Dunbar states, "it enables the central institution to supply an almost indefinitely large demand for currency for domestic purposes without involving itself in any appreciable danger of loss of gold through presentation of the notes for redemption. On the other hand, if notes

¹ E. D. Jones: *Economic Crises*, Page 112.

² E. D. Jones: *Economic Crises*, Page 111.

are issued by many banks, in a serious emergency it may happen that the public loses confidence in the notes and manifests a preference for gold.”¹

PART III.

Elasticity of Bank Note Issue.

If then a Central Bank or a Reserve Bank is established in India with the sole right of note issue, what other advantages would accrue to the country? It would make the note issue elastic.

Elasticity is an essential quality of a good currency system. It means “responsiveness to present increase or diminution of demand,— *the power of adaptation to the needs* of the month, the week, or the day, whether rising or falling.”² The volume of currency should vary freely in response to the varying requirements of trade.

This elasticity could be obtained at a particular time by moving currency from one place where it is not needed to another where it is urgently needed. This quality can be more correctly designated *mobility*. But this is only possible if there is a surplus of currency in the first place which *it could well spare and if at the same time the transport system is so excellently developed* that the transmission of currency is affected instantly and quickly. But these conditions are rarely obtained. It, therefore, follows that currency should have the capacity to increase or decrease in volume to meet the varying needs of trade.

In most countries, and particularly in a mainly agricultural country like India, there is a much greater demand for currency at certain periods than at others during the year. These great streams of demand arise from the

¹ The Theory and History of Banking, Pages 79-80.

² Dunbar: Economic Essays, Page 238.

necessity for financing the movement of crops. And this seasonal need for finance fluctuates widely according to the abundance of crops and the prices they command. This, therefore, brings a great strain on the resources of the banks. 'The amount of Government paper which it suits the banks to hold, since it must be held all the year round, is not suddenly expansible : nor is it easy for them suddenly to liquidate their holdings or from the Government's point of view, desirable that they should.'¹ Hence the elasticity of notes based on Government paper is very limited. The great streams of demand increase the volume of exchanges which require an adequate increase in the medium of exchange. This increase may be obtained either by the deposit and cheque system or by borrowing on the part of one bank from another or by a Central Bank issuing its own notes and basing some part of them on the backing of commercial bills depending for their existence on a well developed bill market. As explained previously, it is a Central Bank issuing its own notes that is in the best position to know market conditions and to adjust the supply of medium of exchange to its demand. *Commercial Bills are the essentially suitable backing to that part of the note issue by a Central Bank which is fluctuating and called into existence in the busy season only.* It was shown in a previous section that basing note issue on the discount of bills of exchange is the best method of introducing elasticity for the mechanism is *automatic* (See page 19). 'Bills are the pivot on which the whole meaning and utility of the note issue essentially turns,'² and that is why the charters of

¹ Annexe to the Report of the Chamberlain Commission: J. M. Keynes.

² J. M. Keynes: Annexe to the Report of the Chamberlain Commission.

most Central Banks provide for their note issue to be secured partly by commercial bills.

In order to give elasticity to currency during the busy seasons in India the currency authority is allowed by statute to issue currency notes up to a maximum limit (at present the amount is Rs. 12 crores) against hundis or internal bills of exchange.¹ Although this has helped business, it is not found in practice sufficient to meet the emergency. Besides, in India, as internal trade is financed by a system of cash credits or by the advance of money against demand promissory notes, it is difficult to secure a sufficient volume of bills on the backing of which this seasonal demand could be satisfied. The Government is, therefore, compelled to resort to the regulations of its holdings of sterling securities in the reserve.

India's need for elasticity of currency is great for another reason. In Europe and America deposit banking has so well developed that the *cheque system* gives additional elasticity to currency. When a cheque is transferred from person to person it is equal to so much currency changing hands. For instance, if a negotiable cheque for Rs. 10,000, has passed through 10 different hands the total amount saved is Rs. 100,000 which means that a cheque has introduced currency to the extent of Rs. 1 lakh. Hence the greater the number of persons through whose hands a cheque passes, the greater is the addition to currency ; and the better the development of the Clearing House System the greater will be this frequency. But this rapidity of movement of cheques is possible in *commercial centres* where it serves its purpose well. "In the case of a demand for an increased medium of exchange upon the occasion of special financial operations in the

¹ The subject is again dealt with in Chapter XI.

cities like the issue of a new loan, or the payment of dividends, the medium of exchange furnished by deposits and loans is usually sufficient.”¹ But experience has shown that deposit currency is not acceptable and sufficient for the needs of *rural districts and especially of the agriculturists and labouring classes.*

India's special disadvantages. In this respect, India suffers from two special disadvantages. Joint-Stock banking and the use of cheques as currency have no doubt been developing in India and particularly since the establishment of numerous branches of the Imperial Bank of India, but still the development is not nearly commensurate with the elasticity needed by the country. Moreover, the need for seasonal expansion and contraction in India is particularly pronounced owing to the mainly agricultural character of its internal economy, and neither India's joint-stock banking nor the issue of Government paper has been able to give that elasticity of credit necessary to promote her increasing trade activity. Thus, India's salvation lies in the issue of bank notes by the institution of a Central Bank in the country.

(The subject is again dealt with in succeeding chapters.)

PART IV.

Stability of the monetary unit.

‘An essential function of the Central Bank is the maintenance of the stability of the monetary standard.’² Before studying how this function is established, it is necessary to emphasize what this stability is and what its importance is in the economy of a country.

¹ Conant : The Principles of money and Banking Vol. II, Page 134.

² Kisch and Elkin : Central Banks, Page 72.

This stability relates to the *purchasing power* of the monetary unit (1) *internally* and (2) *externally*. Its internal stability results in the stability of the general level of *commodity* prices ; whereas its external stability results in the stability of the exchanges.

(1) Internal stability of commodity prices :—

It is extremely desirable that the general level of commodity prices in a country should remain stable over relatively long periods. It is because 'the economic organization of the civilised world to-day rests on credit or deferred payment and on contract which defines the manner and time of payment.'¹ A manufacturer enters into a contract with a wholesale dealer in, say, January to deliver him 10,000 units of the manufactured commodity at a certain price in March. The manufacturer on his part has agreed to the price because he relies on producing them at the anticipated cost price (thereby making a profit) ; and the merchant on his part has agreed to the price because he anticipates the sale of the units to the retail traders with a margin of profit. The retail traders have made contracts with the wholesale dealer at a particular price for delivery of the goods in March because they anticipate that consumers will buy them at a price to bring them some profit.

But all of them have contracted on one assumption, namely, that the purchasing power of the monetary unit remains nearly the same during the months January to March. If, however, the purchasing power changes, that is, if prices rise or fall, a disturbing element is introduced in the fulfilment of contract. Thus the element of *time* brings with it great risks and uncertainties in the fulfilment

¹ Wadia and Joshi: Money and Money Market in India, Page 19.

of contracts. These risks are due to two different sets of causes, some of which are unavoidable, whereas others are capable of being redressed. If, for instance, during the interval that elapses between the signing of a contract and its fulfilment, the rains fail, a shortage of raw materials both for commerce and industry would follow and strike at the very root of the contracts entered into. But no business man would grudge the calamity. It is due to nature and all must suffer equally. Indeed, it is not suggested that during the interval the purchasing power of money will not change. Absolute stability in a number of years is unthinkable.

But if the change in its purchasing power is brought about by a *maladjustment of supply to the demand for monetary circulation*, then the community has a legitimate right to protest against it, because it is neither due to natural causes, nor to world causes, nor to their own fault. If then the amount of money exceeds the real needs of the country, its supply will exceed the demand and its price will fall, i.e., its purchasing power will be reduced, in other words, the general level of prices in the country will rise. It is unjust to creditors who, when they gave away their goods or money in the past, gave greater purchasing power than what they are compelled to accept now when their debtors return their obligations to them. If, on the contrary, by a maladjustment the supply of money falls short of the demand it would be unjust to the debtor class who, when they pay their debts in money, give away greater purchasing power than what was given to them when the level of prices was higher.

Creditors or debtors may suffer at a given time by a change in the price level due to natural causes or world causes, but they must not be made to do so by any arti-

ficial change brought about by a maladjustment of the supply of money to the demand.

The conclusion naturally drawn is that in order to obtain internal stability the monetary circulation should be restricted to the needs of the country. In emphasizing this statement the Hilton-Young Commission wrote, "so long as the volume of the monetary circulation does not exceed, or fall short of, the amount of money at any time needed for the exchange of the quantity of goods and services which have to be exchanged (regard being had to the 'velocity of circulation' and the frequency with which goods and services are exchanged) the purchasing power of the rupee will remain stable." Indeed in deciding the restriction of the monetary circulation, consideration has to be shown to other factors, (such as, 'velocity of circulation of money',) which play their part. Thus the oftener a rupee passes into many hands the fewer rupees are needed to do the same amount of transactions.

(2) External Stability :—

'But internal stability is the main factor to achieve the external stability of the monetary unit. To appreciate this, we need only think of the repercussions which instability of the general level of internal prices has upon the foreign trade of a country.'¹ Suppose the general level of prices in a country rises (that is, the purchasing power of money falls) relative to the world level of gold prices. Then this would be a good country in which to sell commodities but a bad one in which to buy them. Hence imports will be encouraged and exports discouraged, with the result that the balance of trade will become unfavourable to the country, and the exchanges will be upset.

¹ Report of the Royal Commission on Indian Currency and Finance, Page 46.

'And internal depreciation of the monetary unit thus very soon produces external depreciation.' And the reverse is the case when there is a fall in internal prices relative to the world level of gold prices. Thus, if internal stability is secured it will prevent these repercussions and will thereby prevent instability of the external value of the monetary unit, that is, of the exchanges.

What is the machinery to accomplish stability? But the stability of the purchasing power of the monetary unit could be achieved by the institution of a Central Bank which is given adequate machinery to enable it to establish it. It should be given (1) *the sole right of note issue* and (2) *the power to impose upon the country a judicious credit policy*—these give the Reserve Bank the means to control the volume of the monetary circulation in India, and thus to stabilise the purchasing power of the monetary unit.'

(a) *Instrument to secure internal stability.* If the two functions are given to the Bank it will be in a position to expand or contract currency adequately to meet the real needs of the country and thereby establish stability. It was seen before that in a country like India where business is mainly centered in agriculture, these needs fluctuated widely and elasticity of currency was imperative. If, therefore, *note issue is partly based on commercial bills* (or Bankers' Acceptances which will be explained further), the expansion and contraction of currency will become automatic because, as explained previously, the commercial bill is a 'self-liquidating asset', that is, as soon as the transaction is liquidated it liquidates the bill. When there is need for expansion, on the strength of the bills, currency is given away (that is, expansion takes place); but when the bills

get matured and are liquidated (when the increased monetary circulation is no longer needed) the currency automatically returns to the Bank (that is, contraction takes place). So far it is assumed that a Central Bank is a perfect credit machinery—perfect in estimating accurately the currency needs of the country from day to day and perfectly independent in taking prompt action to meet the needs. But can a human mechanism be so perfect in its estimate of present forces as well as of those anticipated in the near future? There are certain forces which it cannot control, however anxious and vigilant the Central Bank may be, and the most important of these is the inherent weakness of the standard of currency established in a country.

The monetary history of the countries of the world, particularly during and after the Great War, has taught one great lesson that “*the only monetary system that secures relative stability in prices is one that is based on a gold standard.*”¹ No Central Bank has ever achieved by its management of currency monetary stability in any country that had not either gold currency or a gold standard.

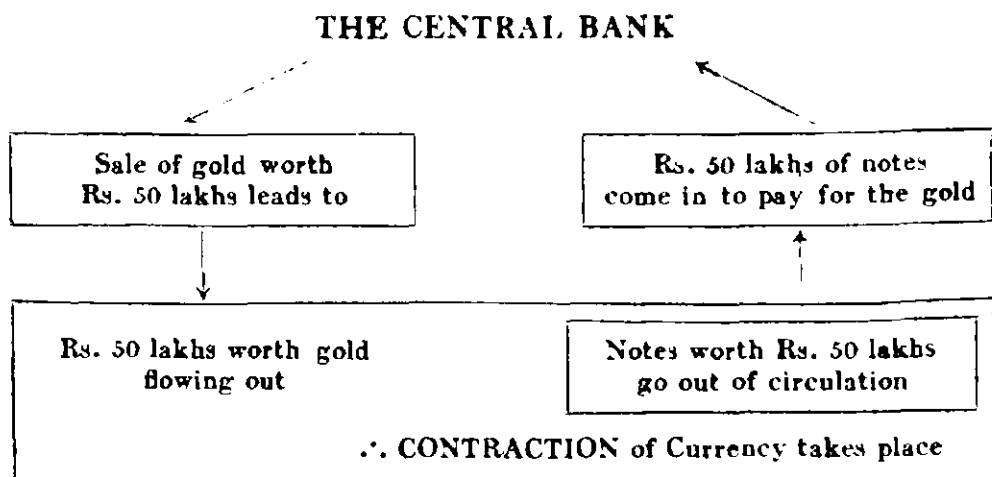
(b) *Instrument to secure External Stability.* In order to secure external stability of the monetary unit, it should be the function of the Central Bank to buy and sell gold to the public whenever demanded by them for receiving and making foreign payments.

Although internal stability is the principal condition to establish external stability of the monetary unit, it is essential that the note issue should be secured to a substantial extent by assets ‘which are capable of rectifying a temporary disequilibrium in the foreign balance of pay-

¹ Wadia and Joshi: Money and Money Market in India.

ments.' Suppose at a particular time owing to some cause, such as a bad harvest, the balance of trade goes against India, that is, India has to pay more to foreign countries than she has to receive from them. In such a case, *gold and gold securities are the assets most suitable*, for they can be quickly employed to pay for foreign indebtedness, until such time as the Central Bank may correct the trade balance by other devices, like raising the rate of discount, to which we shall refer in another chapter.

It is necessary to know the general economic effect of the sale of gold by the Central Bank under the conditions stated above. When gold is sold by the bank to business men for meeting their foreign obligations they are paid for in notes : so that the notes get *withdrawn from circulation* to the amount of the gold sold. Thus, *contraction of currency* takes place. This is explained in the following diagram.



And this results in a *fall in the general level of prices*, since less currency circulates with the same amount of commodities as before. And when the general price level

has fallen, commodities are cheaper than before, therefore, exports are stimulated and imports are discouraged, and the adverse situation would tend to become corrected.

But this contraction postulates two essentials :—(1) that notes are the *only* currency circulating, and that (2) the notes paid to buy gold are from *circulation*. If these essentials are fulfilled, it would be easy to determine how much gold reserve the Bank should keep, and as there is a limit beyond which contraction of the monetary circulation cannot be carried, the amount of gold corresponds to this limit.

PART V.

The Case of India.

THE CASE OF INDIA :—In India the internal circulation consists of notes and rupee coins, both of which are unlimited legal tender. And the problem is more complex because it is difficult to assess accurately the amount of rupee coins in circulation and a very large proportion of rupees issued is held as a store of wealth by the people rather than as an active medium of exchange.¹ Thus, if the *rupees from the hoards come out* to purchase the gold at the Reserve Bank, contraction of monetary circulation will *not* take place, and internal prices will be affected. Besides, there will be an additional strain on the resources of the Bank. In order to guard against the danger, a large gold reserve is necessary.

“GOLD BULLION STANDARD” FOR INDIA :—For the automatic expansion and contraction

¹ The official statement submitted to the Hilton-Young Commission showed that the total amount of rupee coins at that time was from 350 to 400 crores; of this amount 150 crores could never be spared from circulation. Taking the figure 400 crores the conclusion is that 250 crores represent the amount which does not primarily serve monetary purposes.

of currency to maintain the exchange value of the rupee, the Royal Commission on Indian Currency and Finance, (1926) have proposed the '*Gold Bullion Standard*' for India. They propose that an obligation shall be imposed by statute on the currency authority to buy and sell gold without limit at rates determined with reference to a fixed gold parity of the rupee, but in quantities of *not less than 400 fine ounces (1065 Tolas)*, no limitation being imposed as to the purpose for which the gold is required.

The essence of their proposal is "that the *ordinary medium of circulation in India should remain as at present the currency note and the silver rupee both of which are tokens*, and that the stability of the currency in terms of gold should be secured by making the currency directly convertible into gold for all purposes, but that *gold should not circulate as money*. It must not circulate at first, and it need not circulate ever."¹ The present 'Sterling exchange Standard' or the 'Gold exchange standard' is to be cast off definitely and the threat to the Indian Currency System of a rise in the price of silver, which broke down the standard in the past, was to be eliminated once for all. This is the fundamental basis of the new currency reform.

But the Gold Bullion Standard is not to be established in India in its entirety. The proposals are that the Reserve Bank shall be under obligation :

(a) to *buy* gold bars of not less than 400 fine ounces without limit when tendered in India at the *par* rate of Rs. 21-3-10 ps.=1 tola (180 grs.) of fine gold. This is according to ordinary gold standard practice and also pre-war practice in India ;

(b) to *sell* gold bars without limit for delivery in *London* at *par* rate plus a charge covering cost of shipment to

¹ Report, Para 54.

London and loss of interest. These sales are intended to serve a monetary purpose when there is *adverse* balance of trade and is the common gold exchange standard practice ;

(c) and to *sell* gold bars without limit for delivery in *India*. The gold in India will be required for two purposes : (1) *monetary*, when a favourable balance of trade is to be liquidated and (2) *non-monetary*, for social uses. In this case there are limitations applied :—

(i) Gold will be sold *at par rate* (for monetary purposes) only when exchange is *at or above upper gold point* ;

(ii) but at all *lower* levels of exchange the selling charges for gold (for non-monetary purposes) will be *par plus twice* the shipping and interest charge.

The effect of limitation (i) will be that at that point of exchange gold will flow into India in the ordinary course, to liquidate the favourable balance of trade, so that it will not be very necessary for the Reserve Bank to sell gold.

Whereas the effect of limitation (ii) will be to charge such a prohibitive rate that the public would *not buy* gold for non-monetary uses from the Reserve Bank, which will consequently preserve its gold stocks for purely monetary purposes. A deterrent rate is therefore applied. The reasons given are that if gold is ordinarily sold to the public for non-monetary uses at *par rate*, it would become the cheapest source for buying gold and would thus destroy the bullion market, and being the cheapest source of supply for gold, the Reserve Bank would encounter so heavy a demand that it would be compelled to establish a restrictive credit policy. The Commission have therefore proposed rates making it cheaper to import gold from London than to buy it from the Bank when the exchange is below upper gold point.

The consequences of these proposals will be that (1) India's Standard will be based not on Sterling but on *gold*. When the balance of trade is favourable to India, gold will be allowed to flow freely to India, and when the trade balance is unfavourable gold will flow out of India. The special advantage to be gained by India is that *gold will be paid for the country's exports* and not silver. (2) But the relation between the rupee and gold will be supported by the two obligations on the Reserve Bank to buy in India gold at par, and to sell gold in India for delivery in London at the rate proposed.

Thus, with a favourable trade balance the gold which will flow to India may be exchanged at par by exporters at the Reserve Bank for notes or rupees. By this process, expansion of currency will take place. But when the trade balance goes against India, importers will exchange the notes and rupees for gold, with the result that contraction will take place. Consequently, there will be *automatic expansion and contraction of currency* and the disturbing influence of the hoarded rupees will be obviated.

SUBSEQUENT AMENDMENTS :—As will be shown in Chapter XV two important changes were made in these proposals in the Bill introduced in the Legislative Assembly of India. As shown above, the minimum amount of gold to be purchased or sold was fixed at 1065 tolas (or 400 ozs.). This figure was reduced to 250 tolas as being a figure more suited to Indian conditions. And the obligation to sell gold for delivery at foreign centres was replaced by a *permanent obligation to sell gold exchange* from the outset in any gold standard country notified in this behalf by the Government of India. The advantages claimed were that the obligations imposed on

the Reserve Bank to keep stable the value of the currency would be made capable of fulfilment by this provision and that it would be possible for a greater proportion of gold to be held in India. (See Chapter III.)

CHAPTER III

SYSTEMS OF CENTRAL BANK NOTE ISSUE

When a Central Bank is given the sole right of note issue, it follows as a corollary that it would be compelled by law to make the issue *secure*, i. e., the convertibility of the notes into specie should be absolutely guaranteed.

An ideal note issue system should bring not merely (a) elasticity and serve the best interests of business and trade, but (b) must ensure convertibility into specie at all times and (c) at the same time guard against undue expansion or *over-issue* on the one hand, and undue contraction or *stringency* on the other.

In order to secure convertibility and to prevent the possibility of over-issue, various regulations have been laid down by different countries, but these take two general forms :—(a) those that are formed to *fix a maximum limit* to the amount of the notes to be issued by the Bank, (b) and those which regulate *the reserve*.

PART I.

The Chief Systems of Note Issue.

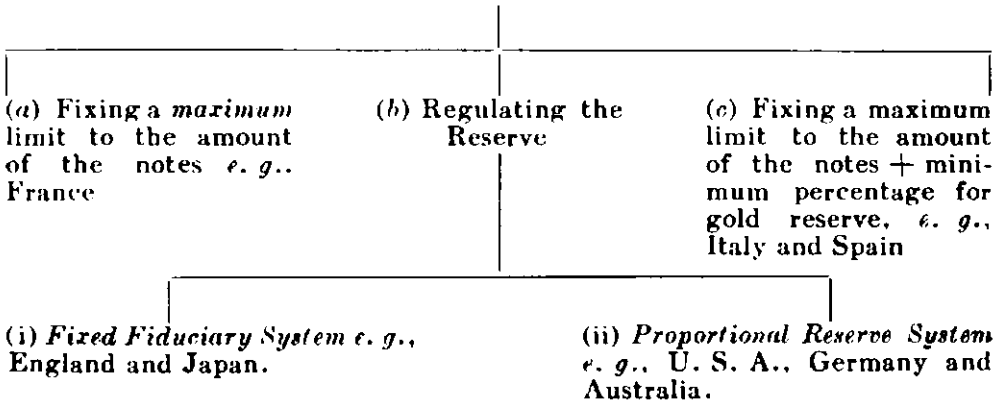
The classification (vide p. 39) illustrates generally the chief systems prevalent in various countries.

The chief characteristics of these systems will now be stated in order to ascertain which particular system would serve the purpose of India best.

(a) *Maximum fixed* :—The first system is introduced in France where the maximum limit of the issue of notes

is fixed and altered from time to time in accordance with the needs of trade. Thus, in 1926 the legal maximum

Regulation of Note Issue



fixed was 59,431 million Francs.¹ It is evident that this system is not merely inelastic, but in fixing the maximum it pays no regard to the intimate connection that constantly exists between note issue and the requirements of trade.² Besides, before the actual maximum is raised by the Legislature, there is bound to be some period of inconvenience to business and trade which have to await such sanction. The system, therefore, is likely to be cumbrous.

(b) *The Fixed Fiduciary System* :—This system is typically represented by the Bank of England.³ Its essential features are the following :—

¹ Spalding : Dictionary of World's Currencies and Foreign Exchanges.

² 'Since 1914, the maximum has been increased by law on a number of occasions, without due regard of consequences, but when the country was on a gold basis expansion was carefully controlled.' Kisch and Elkin.

³ By the Bank Charter Act of 1844 this system was adopted by England. "One of the chief purposes of the Bank Charter Act was the mitigation of Crises by preventing the inflation of the Currency. The Bank endeavoured to meet subsequent crises, not by the power of the Act, but by its suspension. This method has, however, proved useless". Stephenson : The Principles and Practice of Commerce, Page 377.

(a) The Bank of England is authorised to issue its own notes on the security of Government debt to an amount fixed by statute, i.e., £14,000,000.

(b) *But any additional notes over and above this fixed fiduciary limit have to be secured by a gold backing of 100 per cent.*

(c) The business of note issuing and banking is separated by law into separate departments, called the 'Issue Department' and the 'Banking Department.'

(d) The Reserve in the form of notes that are created, but not actually put into circulation, is held by the Banking Department. The maximum of this reserve constitutes the limit to which the currency can be expanded.

(e) If more currency is needed, as for instance in a severe crisis, nothing remains but to suspend the Bank Act, and thus give the Bank the privilege to issue notes unsecured by gold. This has actually happened three times in its history.

ADVANTAGES OF THE SYSTEM:—Under this system it is rightly laid down that there is a minimum of currency always remaining in circulation unless the mechanism of exchange should break down completely; and so long as currency is issued up to the maximum limit, there is no danger of the purchasing power of money being adversely affected. Besides, the expansion and contraction of note issue beyond the fixed fiduciary limit takes place at a rate exactly equal to the increase or decrease of the gold reserve. Hence this system brings security at the expense of elasticity.

But "although the Bank's note issue is regulated on rigid lines, the ratio of the Banking Department of the Bank of England is subject to no statutory restriction and hence the proportion has always been permitted to vary

widely from time to time. By these variations the Bank has been able to impart an elasticity into what otherwise would have been a rigid frame."¹ However, although the rigidity of the note issue is modified by the elasticity of the Banking Department, it must not be forgotten that the Act had to be suspended because the assets were not sufficient to meet the obligations of this department.

But apart from this, elasticity (or expansion and contraction) of currency takes place through the cheque system of the very highly organised banking system of the country.

A change has been brought about by the Currency and Bank Notes Act, 1928. By this Act the Bank of England is authorised to issue notes against the Issue Department's total holding of gold *coin* and gold *bullion*, and in addition, to issue notes *against securities* to an amount of £260,000,000. This fiduciary limit cannot be increased except by sanction of the *Treasury*, immediately communicated to Parliament. But any such authority applies only for a period not exceeding six months, and it may be renewed for a further period of six months, provided that no fiduciary circulation shall exist for more than two years without express Parliamentary sanction.

It will be found that the principle of fixed fiduciary issue established by the Bank Charter Act is retained, but the crude method of suspending the Bank Act is replaced by a simpler and more certain method and has thereby met the demand for a more elastic note issue.

The Bank of Japan is permitted by law to issue Bank notes to an amount not exceeding Yen 120,000,000 on the security of Government debt, other reliable securities or commercial bills. But any issue over and above this

¹ Kisch and Elkin: Central Banks, Page 88.

limit is to be secured 100 per cent. by gold and silver. The principle is the same which underlies that of the Bank of England.

(ii) *Proportional Reserve System.* The Proportional Reserve System is in operation in the United States of America under the Federal Reserve system, in Germany (and other European countries) and in South Africa. Its essentials are that

- (1) It does not require the note issuing and banking functions to be separated into two different departments.
- (2) Under it, notes in active circulation are secured by a *minimum percentage* of gold and gold securities which is laid down by law, and which is 40 per cent. in the case of America.
- (3) These minima are not rigidly fixed but may be *transgressed with the consent of the Government* for *short* periods on the condition that the issuing bank pays the *tax* reckoned on the amount of the deficiency. The tax is made to rise as the deficiency increases.
- (4) As regards the remaining 60 per cent. of the note issue, they are to be secured by certain forms of collateral completely. This collateral consists of such paper as could be rediscounted at a Federal Reserve Bank and bills of exchange which such a bank is permitted to deal with.
- (5) The reserve to be held against *deposit* liabilities is fixed at 35 per cent. gold and lawful money.

ITS ADVANTAGES:—Its chief characteristic is that expansion and contraction do not take place at the same rate as the gold reserve is increased, or decreased, but that it permits expansion, and forces contraction to take place in the proportion of 100 : 40. Thus an addition of 40 units to the gold reserve permits the bank to

issue the notes to the amount of 100 units ; conversely, a loss of reserve of 40 units forces a contraction of notes to the extent of 100 units.

The great virtue of this system is its *great elasticity*. At the same time security is not sacrificed, for expansion above a limit is permitted for *short periods* only, and that a steeply rising tax forces the bank to take prompt measures to redress the situation.

Similarly in Germany the Reichsbank is compelled (a) to keep gold or foreign bills (gold cover) covering at least 40 per cent. of the total circulation. Of this security three-quarters at least must be in gold.¹ (b) This minimum is not rigidly fixed, but may be reduced, as in times of crisis in which case a tax is levied on the deficiency for which a schedule is laid down. (c) The remaining cover has to consist of bills of exchange or such other paper which the Bank is allowed to do business in. (d) And the deposit liabilities of the Bank are covered by 40 per cent. gold.

In the case of Australia, the reserve requirement is only 25 per cent.

The percentage varies widely with different countries and depends on their peculiar circumstances. But the fact remains that most countries have found by experience the percentage basis as the system best suited to bring security and elasticity of note issue.²

(c) *System of Spain and Italy* :—In both Spain and Italy there is a double safeguard introduced in note issue. Not only is the maximum limit put on the issue of notes

¹ Spalding : Dictionary of World's Currencies and Foreign Exchanges, Page 76.

² "There is nothing sacrosanct about these percentages, which are still in the state of experiment. The science of credit control is continuously advancing with the progress of economic development, and if the need arises, improved mechanism will in all probability enable further economies to be made in the use of gold." Kisch and Elkin : Central Banks, Page 83.

but a minimum percentage for the gold reserve is also insisted on. And in the case of Spain the reserve requirement is peculiar. The percentage is made to increase with increase in issue up to the maximum limit.¹ This system pays undue regard to safety and thereby sacrifices the much needed elasticity with increase in business.

PART II.

The System for India.

THE SYSTEM FOR INDIA :—By the proposed legislation of 1928² the Reserve Bank was to have the sole right to issue notes for a period of 25 years. These notes would be legal tender and would eventually replace Government notes. But the system of note issue proposed as most suited to the country is the Proportional Reserve system. In the opinion of the Royal Commission it would not be in the interest of India to adopt the system of the Bank of England, because unlike England, joint stock banking and the use of the cheque as currency have not developed sufficiently to mitigate the rigidity of that system. On the contrary, we repeat, the need for seasonal expansion and contraction for India has been so pronounced owing to its mainly agricultural economy that the Proportional Reserve system alone would seem to satisfy this requirement.

But the danger inherent in this system cannot be denied. “The danger of this percentage system” said Mr. A. C. Davidson, “lies in the cumulative effect of the

¹ Thus for a total issue of 2,000,000,000 pesetas, total reserves of 930,000,000 pesetas, or 46.5 per cent., must be kept, of which at least 570,000,000 must be gold. Spalding :—Dictionary of World's Currencies and Foreign Exchanges.

² Read note with the Appendix.

withdrawal of gold".¹ As stated above, the minimum ratio of gold to notes is 40 per cent. in the case of the United States of America. Assuming that the Commercial Banks usually hold a proportion of 20 per cent. of cash to deposits, what would be the effects of a withdrawal of gold? If the above proportions are actually reached a withdrawal of £40 in gold would necessitate a withdrawal of £100 in notes. But "a reduction of that amount in the cash holdings of the Commercial Banks, should the full effect of the withdrawal of notes fall upon them, would entail a *contraction of credit* well on the way towards £500". Thus, assuming that the actual note issue is really controlled by the proportion, the danger lies in the violent disturbances which are liable to be brought about in the money market of the country. Indeed, the enormous accumulation of gold in the United States of America since the Federal Reserve System was inaugurated has not enabled this danger to manifest itself, but in course of years, when its gold has spread over other countries, the system will be put to a real test. When this has come about "we shall expect to see the minimum ratio system replaced by a system similar to that which obtains and has obtained for many a long year in London Money Market."²

Even the Cunliffe Committee³ appointed in England severely criticised the Proportional Reserve System and rejected it for England on similar grounds. "Suppose for example," they wrote in 1917 that "the proportion of gold to notes is actually fixed at one-third and is operative.

¹ *Central Reserve Banking*:—A paper read before the Perth (W. A.) Branch of the Economic Society of Australia and New Zealand on 28th June, 1928.

² *Central Reserve Banking*: A paper read before the Perth (W. A.) Branch of the Economic Society of Australia and New Zealand on 28th June, 1928.

³ The Committee on Currency and Foreign Exchanges.

Thus, if the withdrawal of gold for export reduces the proportion below the prescribed limit, it is necessary to withdraw notes in the ratio of three to one. Any approach to the conditions under which the restriction would become actually operative would thus be likely to cause even greater apprehension than the limitations of the Act of 1844.”¹ It was also pointed out that the countries whose case was put forward before them as a model were those which had *not in practice maintained the absolutely free gold market* which England, by reason of the vital importance of its position in international finance, was bound to do. But they questioned the very possibility of the ratio being made effective in practice when they wrote “if, as happened in general in the German Reichsbank, other regulations keep the actual note issue much below the maximum fixed by this proportion, the proportion is not effective and produces no result.” Another committee in 1925 reconsidered the question and confirmed the opinion of the Cunliffe Committee that the Fixed Fiduciary System was the safest and most suited to England. The currency history of various European countries having the Proportional Reserve System lends support to this view. It was countries with this system that had the worst currency depreciation in the years which followed the War, ending in the total repudiation of their liabilities in some cases, and it was England which came out of these years unscathed. Should India not learn the lesson of history and safeguard her paper currency system by adopting the Fixed Fiduciary System?

Sir J. C. Coyajee, one of the members of the Indian Currency Commission, 1926, in defending the suggestion for the Proportional Reserve System for India, said in his

¹ The Committee on Currency and Foreign Exchanges.

lecture¹ that the Cunliffe Committee was justified in throwing out this system for England because "it has to be an absolutely free market for gold in an exceptional sense. "By reason of the vital importance of its position in international finance, such a country is constantly subject to very large gold drains and if it had a proportional reserve system its currency would have to be violently contracted as often as there is such a drain. Is there anything similar to these conditions in the case of India?" It is true that for a country like England, which lays itself open to large and sudden demands for gold, a less elastic system is the better. But it could not be denied that undue contraction of currency has been resorted to by countries to save their gold, although they do not occupy the same position as England in international finance. Even a country like India, which is not a gold standard country, had to do so. For example, on February 14, 1929, the Bank rate was raised from 7 per cent. to 8 per cent. because, as a result of the raising of the Bank of England rate to $5\frac{1}{2}$ per cent., the Government of India, as the chief currency authority found themselves "compelled to adjust money rates and avoid a depletion of their gold and sterling reserves." Besides, does the proportional system in fixing the ratio at 100 : 40 as laid down in the Bill for India, not give scope wide enough for inflation of currency? Theoretically it does. But its evil effects would not be made to appear if the institution managing the currency used prudence in doing so. But prudence in management of currency is not constantly obtained, as exigencies of Governments have led to interference and control directly or indirectly of Central Banks which have remained 'independent' only on paper.

¹ A lecture delivered in the University of Calcutta.

On the other hand, the fact cannot be ignored that India has already had bitter experience for decades of the Fixed Fiduciary System, but this has been so more on account of the Government, *without adequate knowledge of the requirements of the money market, managing the currency system*. If the Reserve Bank were to manage its note issue based on this system, the system would have to be made elastic by *raising sufficiently the fiduciary limit* from the experience gained of its working in the past and, until the Bank had organized and developed credit sufficiently for a Bill Market to be established, by introducing special provisions for the issue of seasonal currency.

But it would be better for India to follow the example of the United States of America, South Africa and most European countries and establish the Proportional Reserve System, and keep the ratio of gold to notes *higher than 40 per cent.*, say, for the first ten years and reduce it by special legislation then, after experience has been gained of the working of the system and public confidence in it has been established. This would be a legitimate proposal, because an elastic system would have to be worked by an institution newly created and without any experience whatsoever of currency management, and mistakes are likely to occur in the beginning and lead to loss of confidence on the part of the public.

CONVERTIBILITY OF THE RESERVE BANK NOTES :—The convertibility of the Reserve Bank notes which will displace Government paper is based on the general reform of the Indian Currency System referred to previously. On various practical grounds it was explained that the Commission recommended the '*dethronement*' of the silver rupee and the institution of a *Gold Bullion Standard* for India. They emphasized that

the silver rupee itself is 'a note printed on silver' and that if the paper token currency needs a backing so does the silver token rupee. Besides, the silver rupee had placed the Indian Currency System on various occasions at the mercy of the silver market, with the result that the standard had broken down. The maintenance of the convertibility of the note into silver rupees of the present fineness is only possible so long as silver *does not rise above 48d. an ounce*. The removal of this danger inherent in the silver rupee is the fundamental basis of the new currency reform. Some new, visible and solid basis both for notes and silver rupees must be found, and having rejected the scheme for gold currency, they pinned their faith to *gold bullion* as the backing.

The problem to be considered is two-fold :—

- (1) how to inspire the masses of India with confidence in the currency standard, which they have lost, and
- (2) how to remove once for all the threat to the currency system inherent in the price of silver—'the rupee—melting point'.

The Commission propose to solve this two-fold problem by establishing *gold bullion as the backing* for both notes and rupees and therefore the *ultimate withdrawal of the right of converting notes into rupees*.

Their principal proposals are, therefore, as follows :—

(1) The *new* notes of the Reserve Bank of India (guaranteed by the Government of India) and *rupees* both are to be *full legal tender* and convertible on demand into *bars of 400 oz. fine gold* (or 1065 tolas),

(a) *at par* when exchange is *at or above upper gold point* but,

(b) *normally*, at a *discount* of nearly $2\frac{1}{4}$ per cent. below parity.

The reasons for these limitations will be stated further.

(2) The *new* notes are *not* to be *legally convertible into rupees* but are to be *freely encashed in practice if people desired to exchange them for rupees*.

(3) The coinage of silver rupees should be stopped for a long time to come, until the amount of silver rupees in circulation is reduced to the amount required for small change.

As a supplementary means to dethrone the silver rupee they propose the reintroduction of one rupee notes (which were so popular during the War) which should be full legal tender but which like other new notes, should not be convertible by law into silver rupees.

No greater economic benefit could accrue to India than that notes should be made freely convertible into gold at par, but the limitations under which they could be exchanged for gold would *not in practice* make them more popular than the old notes. Although the proposed Reserve Bank Bill reduced the minimum weight of gold bars from 400 oz. (1065 tolas) to 250 tolas, the minimum sum necessary for such conversion would be (according to the rate, Rs. 21-3-10 ps. = 1 tola of gold laid down) about Rs. 5,300. Besides, normally, they would be convertible at a discount, and as the rate for conversion would be fluctuating, a gold note would not entitle the holder to receive a fixed quantity of gold in return. For these reasons it is difficult to expect that the new note would be in ordinary daily use unless it was made exchangeable into rupees in practice, to inspire confidence in its convertibility. And in practice it would be exchangeable for rupees merely. Its real value would be in foreign exchange, but a very small percentage of the total population would actually need notes for that purpose and the public gener-

ally would remain quite uninfluenced. However, the termination of the convertibility of the new notes into silver rupees and their convertibility into gold bars would be a currency reform of real benefit to the country.

COMPOSITION AND LOCATION OF THE RESERVE :—As regards the Reserve requirements the Bill lays down that :—

(1) Of the total amount of the Reserve, *not less than two-fifths* shall consist of gold coin, gold bullion or *gold securities* : Provided that the amount of gold coin and gold bullion shall *not* at any time be less than thirty crores of rupees in value, “and shall not be less than one-fifth of the total amount of the Reserve after the end of the fifth year or than *one-quarter* of the total amount of the Reserve after the end of the tenth year, from the date on which this Charter comes into force.”

(2) The remainder shall be held in rupee coin, Government of India rupee securities of any maturity and such bills of exchange and promissory notes drawn and payable in British India as are eligible for purchase by the Bank.

A limit is put to the amount of *rupee coin* in the Reserve which eventually has to be fifty crores of rupees or *one-tenth* of the total amount of the Reserve and the *rupee-securities* shall not exceed *one-fourth* of this amount.

(3) Of the gold coin and bullion held in the Reserve, not less than seventeen-twentieths shall be held in British India in custody of the Bank and its agencies : Provided that gold belonging to the Bank in *any* other bank or in *any mint or treasury* or in transit may be reckoned as part of the Reserve.

SOME SPECIAL FEATURES :—There are some important inclusions in the Bill which need special mention.

(A) Unlike the Federal Reserve System, the issue and banking departments are to be separated. The separation is introduced because many Indian business men urged it on the ground that the simplicity of keeping accounts would inspire greater confidence in the Bank note.

(B) The second feature relates to the gold securities stated in (1) above, which may be held as part of the Reserve and shall be securities of any of the following kinds payable in the currency of any *gold standard country* recognised as such by the Government, namely :—

- (a) *balances at the credit of* the Issue Department with a bank which is the issuing authority of a gold standard country or with any of the Federal Reserve Banks in the U. S. A. ;
- (b) *bills of exchange* bearing two or more good signatures and drawn on and payable at a place in *any such country* and having a maturity not exceeding ninety days ;¹
- (c) securities maturing within five years of the Government of *any gold standard country*.

In this respect the example of the newer bank statutes of various countries is followed. These “allowed foreign claims in gold to be reckoned as part of the legal reserve, the nature of such claims being carefully defined so as to ensure that they are absolutely secured and can be quickly liquified.”² Such is the case, for example, in Ger-

¹ The Joint Committee of the Indian Legislatures had objected to this inclusion. Reference will be made to it in chapter XV.

² Statement of Objects and Reasons affixed to the Bill.

many and a similar liberty is to be given to the Reserve Bank of India.

So long as the holding of the securities of foreign countries is limited to short-time maturities the investment would be safe. But the danger inherent in investing the reserve in securities maturing within five years must be emphasized. The late Mr. B. F. Madon, wrote "If holding the securities of other countries is sound, why does not the Bank of England hold some of its currency reserves in this form and earn interest? England may be foolish, but why does Germany, who has an adverse balance of payments, actually borrow money in England or America, then convert it into gold and take it away to Germany? Why does it incur the loss of interest on these borrowings and convert them into sterile gold?"¹ Sir J. C. Coyajee defended the investment in securities of other Governments in 'short-dated' maturities on the ground that "we in India are short of eligible commercial bills."² But the point at issue is whether it is safe to invest the reserve in securities of foreign countries maturing within five years. India has had bitter experience of such investments, even in sterling securities particularly in the year 1920, and she would be throwing away the lesson of history if she sacrificed safety to accumulating interest on such securities.

The Reserve is essentially meant for '*bad times*' and it is during such times that the Bank would be compelled to realise its investments. It would then find, to its dismay, that the securities had fallen in price. Is there any barometer which would give a warning to the Bank that a War was coming so as to enable it to be quick enough to sell

¹ Memorandum on the Reserve Bank of India Bill, Para 35.

² A Lecture delivered in the University of Calcutta.

off foreign securities before they depreciated? But apart from this, are the foreign securities not liable to fluctuations (within five years) owing to local disturbances? Besides, securities of foreign countries do not serve the purpose of the Reserve, but on the contrary, accumulate panic and hasten a crisis if there is any local disturbance in a foreign country or any apprehension of one occurring.

The same argument may be applied against the proviso that gold belonging to the Bank which is in 'any other Bank' may be reckoned as part of the Reserve. The only exception which may be made in this respect would be England, because gold is not liable to the risks to which investments in securities are exposed.

(c) The third feature relates to the keeping of bullion in the reserve *in India*. It is laid down that 85 per cent. of the gold should be kept in the country.

PROVISION FOR EMERGENCY CURRENCY :—Section 41 of the Reserve Bank Bill deals with the suspension of Reserve requirements and a tax on note issue in case of an emergency. By 'emergency' is meant a time of stress and not the normal demand for seasonal currency. It gives power to the Bank to reduce the *statutory minimum proportion of gold to notes in circulation on the payment of a tax on the deficiency*. But such power has to be obtained with the previous sanction of the Governor-General-in-Council for periods not exceeding 30 days in the first instance and can be extended from time to time by periods not exceeding 15 days. The tax is graduated on a rising scale and must be *added to* the rate of discount charged by the Reserve Bank. It is to be the Bank rate *plus* 1 per cent. per annum when the holding of gold reserve is less than 40 per cent. but more than $37\frac{1}{2}$ per cent. of the total amount of the Reserve, and for

every subsequent reduction of $2\frac{1}{2}$ per cent. of reserves the tax is increased by $1\frac{1}{2}$ per cent. But the tax shall *not* in any event be payable at a rate less than 6 per cent. per annum. The actual period of suspension and the scale of the tax is taken from the Federal Reserve System of America.¹ The rate of interest to be charged by the Bank under such circumstances to its customers will be severely penal (Bank-rate plus tax) and will tend to put a check immediately on their demand for currency.

¹ Federal Reserve Act, Section 11 (c).

CHAPTER IV

THE SERVICE OF A CENTRAL BANK TO THE MONEY MARKET OF A COUNTRY

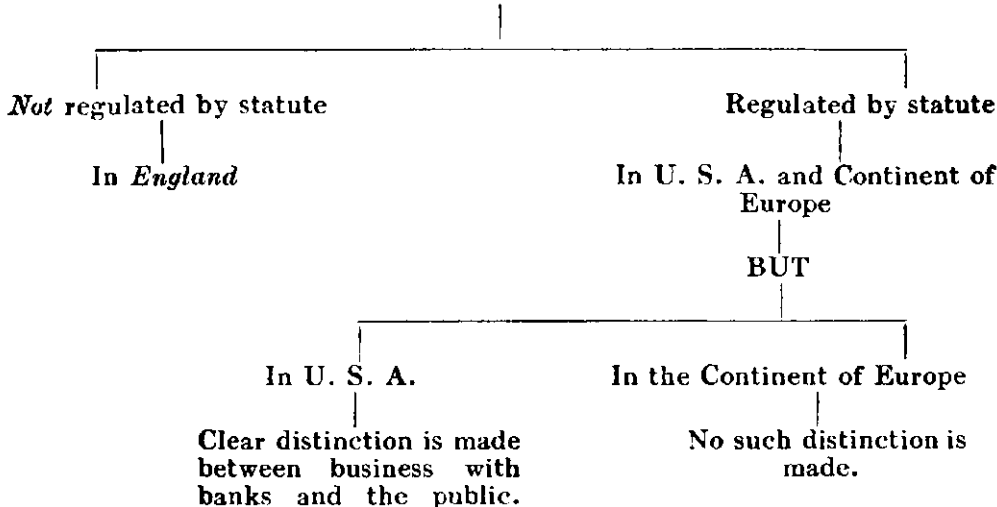
We now turn to those activities of a Central Bank by which it controls and moulds the entire structure of a country's credit and gives it the benefits of a sound banking organisation. The first important point to notice in this respect is the relationship that exists or is made to exist between the Central Bank and the commercial institutions of a country.

PART I.

General Relationship of the Central Bank to Commercial Institutions.

Since a Central Bank is the final authority in matters of banking, it stands to reason that not only should its relation with other banks be defined but the nature of its business ought also to be regulated. There are fundamental differences existing between various countries as regards the relationship of the Central Bank with the other banks of the country and the nature of banking business. These differences are analysed for convenience in the following table :—

RELATIONSHIP OF BANKS AND BANKING BUSINESS



Central banking in England differs fundamentally from that of the United States of America and the Continent of Europe in that its relation with the banks and the nature of the banking business it should carry on are *not* regulated by law, whereas in the latter countries they *are* so regulated. And in the Federal Reserve System statutes play so important a part that a clear distinction is made between what business the Federal Banks may undertake with member banks and what they transact with the public ; whereas such a distinction is not made in the Central Banking laws throughout the Continent. The freedom given to the *Bank of England* concerning its banking business is simply due to the extremely cautious and conservative working of the Bank since its institution. In fact, its tradition has allowed such freedom to the Bank of England ; otherwise we find statutory obligations levied on Central Banks universally.

But the greatest peculiarity which distinguishes the Federal Reserve System of America from the Central Banking System of Europe is the *obligation* placed on the commercial banks by law to place a *minimum of their*

reserves with the Federal banks. This minimum is the amount below which the Government considers the commercial banks must not go in the interest of the public, and is fixed in proportion to their demand deposits and time deposits (We shall refer to them in the next section). No such statutory compulsion is made in the case of the European Central Banking system and the amount of the balances which commercial banks may keep with the Central Bank is regulated by *voluntary agreement*.

ADVANTAGES OF THE STATUTORY MINIMUM RESERVE:—The insistence of the statutory minimum reserve in the United States of America is due to the historical growth of banking in the country. "From the first the banking system in this country has given expression to the American ideal of individuality and freedom. Almost any responsible group of people with a little capital could start a bank, and the result is about 27,000 incorporated independent banks compared with a score or two in most of the countries."¹ The number of scattered banks was so large that laws had to be passed forcing each bank to keep a minimum reserve in its vaults. And when the Federal Reserve system was established the only way to enable it to establish control over the thousands of banks was to insist on their depositing a minimum reserve with the Federal banks.² The commercial banks which are affiliated to the Federal Reserve system are at present nearly 9,400 in number.

But in the case of European countries this insistence on the statutory minimum does not exist because the number of commercial banks doing business is small and some

¹ Burgess: *The Reserve Banks and the Money Market*, page 25.

² In the United States of America, the Federal Reserve Bank and Banks had to act as schoolmasters to something like 25/30,000 individual Banks. "Central Reserve Banking: A. C. Davidson."

kind of concentration is already there. Thus, in France there are six credit companies that control banking business, and in Germany ten banks monopolize the business. It is easy, therefore, to establish relationship between the Central Bank and the other banks which could be controlled by it.

In Japan only a few of the commercial banks keep their reserves with the Bank of Japan. "The Bank as a result has been powerless to control their policy..... It is this weakness that has been one of the chief causes of the frequent financial crises in Japan."¹

THE SYSTEM FOR INDIA :—It then may well be argued that in India, as there are very few banks, there should be no legal obligation on the banks to place a minimum of reserves with the proposed Central Bank. But the case of India is different. In the first place, banking is not merely completely inadequate to the needs of the country, but those few banks which do business are divided and classified separately into groups according to the nature of the business they transact. Far from there being any co-ordination between them, there is a division of functions and consequent indifference towards each other's progress. Besides, there is no stability in Indian banking and experience has proved that the failure of some of the banks in the past was due to their lending credit without any adequate reserve. They, too, used their reserves for speculative investments. The very foundation of the structure is unstable. "There is a multiple reserve system in theory but hardly any adequate one in fact; and a danger exists that every one is reckoning in a crisis upon every one else."² To add to this, the temper of the mil-

¹ Kisch and Etkin: Central Banks: Pages 9-10.

² Keynes: Indian Currency and Finance: Page 237.

lions of uneducated people has also to be reckoned with, and the fact that Indian banking has not as yet touched the masses at all.

The conclusion, therefore, becomes inevitable that if a Central Bank is to be established in India, it is absolutely necessary for the development and stability of Indian Banking that material support should be given to the Central Bank by way of a statutory obligation on the part of the commercial banks to keep a minimum of their reserves with it. Then alone will the Reserve Bank have the power to perform its function of a truly Bankers' Bank.

PART II.

Advantages of Concentration of Reserves.

When a Central or a Reserve Bank is established in a country either law compels the various banks to place a minimum of *reserves* with The Central Institution, as in the U. S. A., or voluntary *agreement* as in Europe makes them do so. The result is the same. The scattered reserves of the banks are removed from the vaults of the banks and become *centralized* in the Reserves of the Central Bank, which then becomes the sole custodian of the banking reserves of the country. The destiny, so to say, of the banks lies entirely in the hands of the Central Bank. Like a good mother the Bank not merely looks carefully after the property of her children but sees to it that good use is made of that property, and with this object in view establishes disciplinary rules for their conduct. In the eyes of a true mother all children are alike. Similarly, the Central Bank looks after the various banks with equal care and affection. Nay, she emphasizes in practice that *esprit de corps*, that common interest, which is essen-

tial not merely for their own growth and development, but also for the service of those for whom they cater.

WEAKNESSES OF THE MULTIPLE RESERVE SYSTEM :—In order to understand the economic value of centralization of reserves, consideration may first be given to a multiple reserve system, that is, one in which the reserves are scattered over various banks. The reserve kept by a bank is the fund set aside against emergencies. However well managed a bank may be, it may be forced to close down by some unforeseen monetary development leading to a general demand on the part of the depositors for a return of their money. If there is a run on the bank, the only means of restoring confidence and easing the situation is to meet the demand of the depositors freely and without delay. But the fund may not be sufficient (and in practice is never found sufficient) to meet the situation at a particular time, and if there is no hope of another bank giving help, it may become exhausted and the situation become desperate.

Besides, when a particular bank is affected, the other banks are not likely to give a helping hand, because bank panic is like an infectious disease which afflicts the minds of business men, so that the banks, far from coming to the rescue of the affected bank, are anxious to strengthen their own resources against a similar fate. And there is the other consideration that, since the banks have no uniting link, their interests are not common. On the contrary, each bank is likely to look upon another as its rival in business and has no willingness to render help.

(A) But when the funds of various banks are pooled with the Central Reserve of a Central Bank, the latter occupies the position, so to say, of an insurance company to which the various banks subscribe their funds to meet

emergencies. In this case each individual bank does not take the entire risk of meeting emergencies on itself, but gets it distributed amongst all its colleagues. In describing the change brought about by the establishment of the Federal Reserve system in America, Mr. Burgess states, "a basal principle which gives greater effectiveness to reserves under the Federal Reserve system is the insurance principle of distributing the risk."¹

But the amount of the combined Reserves becomes so *great* that the emergency of a single bank can be met easily and quickly.² Even if the panic is general and larger demands are made on the Banks, the mobilization of the Reserves in a single mass makes payments possible without any fear of exhaustion. But a still greater advantage lies in the fact that as the Reserves are pooled with the Central Institution, on their combined strength the Bank can intervene vigorously in the country's business by *extending credit facilities liberally*. "When the reserves are pooled with the Reserve Banks; they can be used without being paid out as they form the basis for issues of Federal Reserve notes or further extension of credit."³ But to crown all, the very existence of the Central Bank with its great resources inspires such great *confidence* in the public that a general panic will not possess that terror which it would otherwise have.⁴ Far from

¹ In his book: *The Reserve Banks and the Money Market*, Page 26.

² "Obviously a country's reserve money must be concentrated mainly in one reserve or, at least, in a few large reserves if it is to be effective. It must be marshalled in armies, not scattered in small squads. But these armies must be mobile so that they can be quickly moved singly or in combinations to places of threatened attack. An army's mobility is a big factor in its efficiency—a truth which the great mobility of the armies of the Central Powers in the World-War emphasized." Kemmerer: *The A. B. C. of the Federal Reserve System*, Page 6.

³ Burgess: *The Reserve Banks and the Money Market*, Page 27.

⁴ "When the public knows that gold in abundance is available on demand it does not want much of it, except to meet the normal demands of international Trade." Kemmerer: *The A. B. C. of the Federal Reserve System*, Page 39.

suspicion extending and wild rumours gaining ground business men would probably say to each other. "But the Central Bank is there." Besides, as the Central Bank is the custodian of the Reserves, it is its privilege to enforce prudence on the part of the banks when needed, and this gives them additional strength to meet the situation.

(B) The concentration of the Reserves affords another advantage. It gives *mobility* to the reserves. Money can be rapidly moved from place where it is redundant to another where it is scarce, so that the surplus of one place can be sent to meet the deficiency of another. Scattered reserves are inflexible, unwieldy and incapable of being moved from a place of redundancy to one of scarcity, and cannot be applied with full strength, for they must first be gathered together before they are so applied. Professor Kemmerer emphasizes this quality of the mobilization of the reserves in America thus : "Reserve money must not only be piped into a few large reservoirs, but these large reservoirs must be piped together and there must be a pumping engine of sufficient power to force the reserves promptly and in large quantities to any place desired. The Federal Reserve System creates just this machinery."¹ The actual devices by which this is done will be treated separately.

(C) The method introduced by Central Banks to put some of the combined reserves to use is to establish machinery by which the commercial banks borrow from them on the security of such bills of exchange, promissory notes, drafts etc. as are made eligible by law. But when these loans are given to the commercial banks, as in the case of America, the reserve funds are not usually given away from the Reserve Banks. What actually happens is that

¹ The A. B. C. of the Federal Reserve System, Page 40.

the borrowing bank receives a *deposit credit* at the Reserve Bank, which serves as legal reserve money of the member bank. If the bank is in need of currency it can draw on it and receive notes. Thus borrowing by a bank leads to the creation of the deposits, or when drawn upon, it increases the notes put into circulation. But as the legal limit of the Reserve for deposits is only 35 per cent. for deposits and 40 per cent. for notes, "a Reserve Bank can in an emergency lend to its member banks nearly three times its actual reserves, unless gold is required for export or circulation."¹ Thus concentration of the reserves gives elasticity of reserves. And when it is remembered that the limits could be passed in times of extreme emergency by the payment of a graduated tax, loans could be given by Reserve Banks almost without limit to those giving the required security and willing to pay the increased price. *Concentration of Reserves makes this possible and thereby gives elasticity to reserves.*

(D) *REDUCTION IN RESERVE REQUIREMENTS*:—When concentration of the reserves brings with it mobility and elasticity of the reserves, the latter give greater service and become more efficient and bring various other economies to the country. We can again profit by the experience of America. In this country it has become possible to *reduce the legally required reserves by the banks to a minimum*, all to be held in the Reserve Banks, and "no requirements are prescribed for cash in vault or balances with banks, which are no longer counted as reserves, and the amount of which are left wholly to the discretion of the member banks."² Thus within three years of the passing of the Federal Reserve

¹ Burgess : Reserve Banks and the Money Market, Page 30.

² Burgess : Reserve Banks and the Money Market, Page 32.

Act of 1914 the percentage of reserves required on time deposits (those payable after 30 days notice) was reduced by another Act from 5 per cent. to 3 per cent., and reductions were substantially made also in the requirements on Demand Deposits (i.e. those payable within 30 days) varying with the situation of the banks. Not only is the statutory minimum reduced but there has been substantial reduction in the *discretionary* reserves which the banks keep with them. The reduction in the aggregate of working reserves of all the national banks as worked out by Mr. Burgess has been from 34 per cent. of total time and demand deposits in 1913 to 20.5 per cent. in 1926.

It is easy to see that the reduction in Reserves brings a twofold benefit to the banks : (1) it saves them a large amount of capital which would otherwise have been locked up and which they can now utilise profitably in the form of loans or investments, and (2) they can extend greater credit than before. It, therefore, benefits not merely the banks but business men also.

INCREASE IN SAVINGS :—And where the mobilisation of Reserves in the Central Bank builds up for the investors a solid rock of security for their investments with the various banks, it is no wonder that this element should induce them to increase their investments, particularly in the form of savings deposits with the banks. An increase in the amount of savings deposits (time deposits) is a sign of healthy growth. It postulates confidence on the part of the public in the banks and at the same time makes available a larger source of capital which the banks can loan out to businessmen.¹ Increase in savings deposits, therefore, gives strength to the reserves.

¹ "In the national banks of U. S. A. the amount of time deposits in 1914 was a little over 1 billion, but by the 1906 was over 6 billion dollars." Burgess: *The Reserve Banks and the Money Market*, Page 36

LEGISLATION FOR INDIA :—As regards the deposits which commercial banks will place with the proposed Reserve Bank of India, legislation makes such deposits *compulsory* and in that respect it follows the Federal Reserve Act of the United States of America. The amount of deposits which a scheduled bank shall keep shall at no time be less than seven and one-half per cent. of the daily average of the *demand*, and two and one-half per cent. of the daily average of the *time* liabilities of such bank in India.

THE SACRIFICE TO BE MADE BY THE BANKS :—Taking the statistics of *Private Deposits* with the Joint-Stock Banks in India on 31st December, 1927, the *compulsory* deposits with the Reserve Bank of India and the loss in interest to the banks will be as follows :—

IN LAKHS OF RUPEES

| Class of Banks | Compulsory Deposits with Reserve Bank | Loss of interest calculated at 5% |
|--|---------------------------------------|-----------------------------------|
| I. Imperial Bank of India | 3,60 | 18 |
| II. Indian Joint Stock Banks | 3,20 | 16 |
| III. Exchange Banks . . | 3,44 | 17 |

(N. B.—The amount of Demand and Time Deposits are calculated at 50 per cent. of the total deposits in each case.)

HOW CAN THE SACRIFICE BE REDUCED?

Almost all banks in India have raised opposition to the compulsory reserve clause. The chief argument adduced is that, whereas the banks in the United Kingdom and the United States of America have to keep small balances in their till, in India the position is different. As the vast majority of Indian customers are not yet used to banking ac-

counts and to the system of negotiating cheques, the Indian banks have been compelled to maintain a large proportion of cash in their till. They already keep a balance of more than 15 per cent. of their demand liabilities on hand to make payments over the counter, and the further $7\frac{1}{2}$ per cent. to be deposited with the Reserve Bank in cash will increase their cost of borrowing and will adversely affect their lending rates also.¹ Considering the peculiar circumstances of India one would be justified in suggesting that at least half (if not the total as suggested by the Indian Joint Stock Banks) the compulsory deposits may be in the form of Government of India securities lodged with the Reserve Bank, so that the Banks may earn interest on them.

PART III.

Rediscount.

WHAT IS REDISCOUNT? Another method by which a Central Bank extends its helping hand to commercial banks in times of urgent need is the *rediscount* of eligible paper. Suppose a commercial bank which is doing genuinely good business has already discounted some bills of exchange of its customers and that it has created deposit accounts in their favour accordingly. The bills are in possession of the bank. If then it happens that, before the bills are *matured* i.e. before the fixed day on which the money will come back to it, there is an *unusual pressure from other business men for a demand for cash* say, to finance agricultural produce which is awaiting export from the country, under the circum-

¹ Joint representation made by the Allahabad Bank, Ltd., The Punjab National Bank, Ltd., The Indian Bank, Ltd., and the Central Bank of India, Ltd.

stances the easiest method to obtain ready cash to meet the situation is to *re-sell* the bills i.e. *rediscount* them. *This the bank could do at the Central Bank and obtain cash for the bills.*

ADVANTAGES OF REDISCOUNT :—Thus rediscounting bills by the Central Bank enables commercial banks, when necessity arises, to turn into cash a maximum of their assets (bills of exchange) with a minimum of disturbance to general conditions. Their *assets get quickly liquidated* in times of stress and their cash position is strengthened at the shortest possible notice.

In almost all countries having a Central Bank, except the United Kingdom, commercial banks rediscount bills *directly* with the Central Institution. But in the case of the United Kingdom assistance is given by the Bank of England to commercial banks *indirectly* “by the withdrawal by the banks of funds put by them at call or short notice on the market, with the result that bill brokers and other borrowers have to make recourse to the Bank of England to obtain the means of payment.”¹

INCREASE IN LENDING POWER :—But obtaining ready cash is not the only benefit which commercial Banks reap by rediscounting bills and other eligible paper. Suppose with the institution of the Reserve Bank of India the legal *minimum* reserve to be kept with it by commercial banks is fixed at 10 per cent. of demand deposits and a particular bank is in danger of trespassing this limit because there is a sudden demand for accommodation from customers, but is unable to extend more credit to them. It may take, say, Rs. 10,000 of the bills to be rediscounted at the Reserve Bank. Suppose each bill is for 90 days and that the Reserve Bank charges 4

¹ Kisch and Elkin: Central Banks, Page 107.

per cent. for rediscount. The proceeds will be nearly Rs. 9902 which at 10 per cent. minimum reserve requirement would enable it to create deposits in favour of customers to the extent of Rs. 99020. *Its lending power would thereby increase considerably.*

ELASTICITY OF DEPOSIT CURRENCY :—This leads us to consider other advantages which rediscounting brings with it. In the first place, the illustration shows clearly how, by the process of rediscounting, commercial banks can increase their lending power considerably in times of financial stress. It, in short, secures elasticity of deposit currency.

AUTOMATIC EXPANSION AND CONTRACTION OF CURRENCY :—Secondly, when bills are rediscounted and cash is obtained by commercial banks, so much note currency flows from the vaults of the Central Bank into those of the commercial banks and through their customers it enters into circulation to meet the increased demand. Thus currency gets expanded when expansion is necessary. But when the bills get matured, i.e., the precise date for receiving payment arrives, currency returns to the Central Bank as the debtors, who are the acceptors of the bills, pay off their debts in bank paper. And when the urgent need for money has passed away, those customers who had borrowed money from the commercial banks, and who have by now executed their transactions, return the money to them. Consequently, paper money gets contracted automatically. Rediscount is therefore one of the chief devices by which elasticity of bank note currency is secured. The following diagram explains the automatic process of expansion and contraction of currency brought about by rediscounting bills.

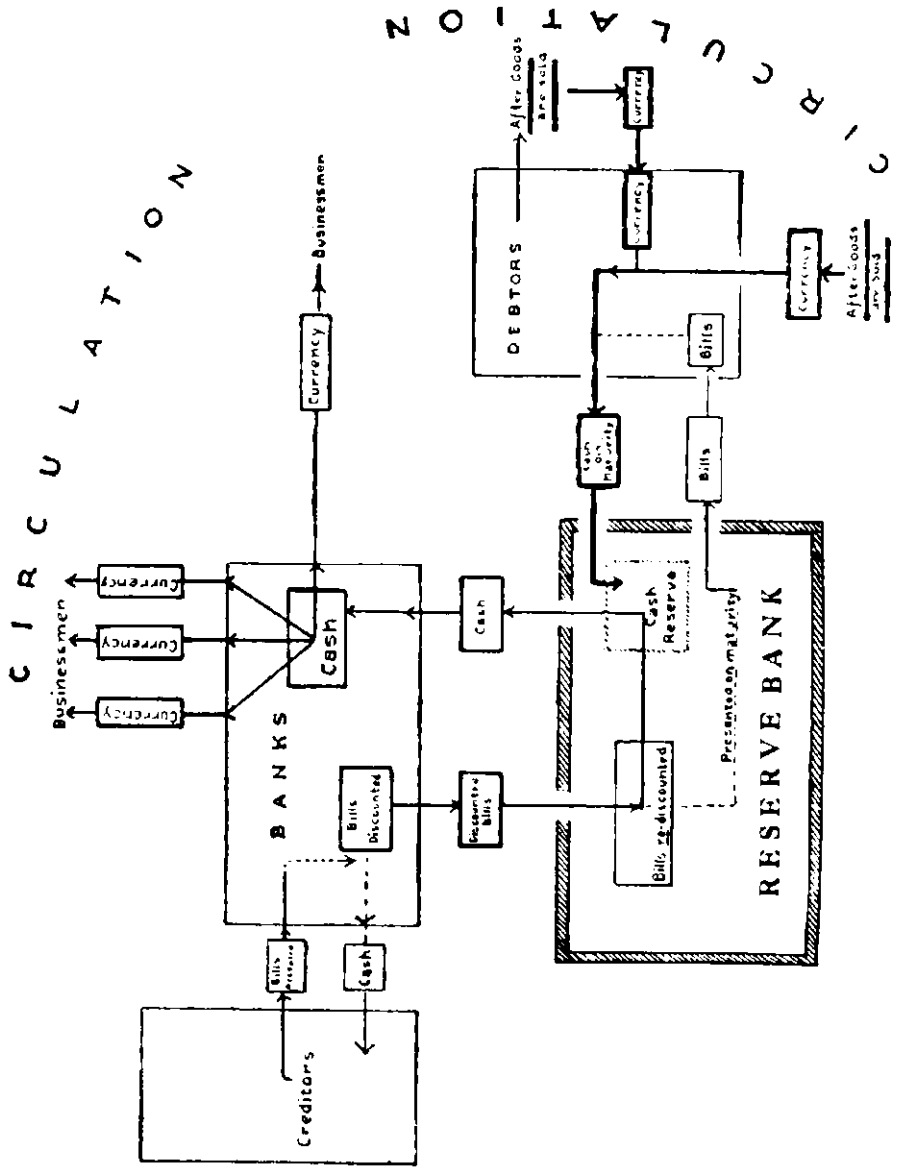


Diagram representing elasticity of currency resulting from Rediscounting Bills.

In the Federal Reserve System of America there is a special provision empowering one Federal Reserve Bank to rediscount the discounted paper of another Federal Reserve Bank. If at a particular time there is an exceptionally heavy demand for money in one Federal Reserve District, which the Reserve Bank is not able to meet, the Reserve Banks of other districts which have surplus of money will come to the rescue, "either voluntarily or

under compulsion of the Federal Reserve Board''¹ by rediscounting its bills, so that the surplus cash flows from the reserves of the helping Banks into the reserve of the needy Bank and the deficiency is well met. Mobility of reserves thereby takes place from one district to another.

ADVANTAGES SUMMARISED. We may now summarise the economic benefits of rediscounting bills :—

(1) It enables the Central Bank to give financial help to the commercial banks at a moment's notice *easily* and *quickly* and *without* any outward disturbances.

(2) It *increases the lending power* of the banks considerably in times of emergency.

(3) It brings *elasticity* of both

(a) deposit currency and

(b) bank-note currency.

(4) And it gives mobility to the reserves.

(Other general advantages are considered with the subject of credit policy.)

WHICH PAPER SHOULD BE REDISCOUNTED? If a Central Bank is to be the sole source from which banks borrow in times of emergency, and if it is to be the ultimate controller of the entire credit structure of the country, it follows that its reserves should be as *safe* as possible and as *liquid* as they can be. Therefore, in giving loans to the banks by way of rediscount of paper rigid restriction should be placed. In framing laws and regulations for permitting the Central Bank to deal in paper, consideration should be given to :—

(1) the *purpose* for which the paper is drawn ;

(2) the length of *time* the paper is to run, i. e., its maturity ;

(3) and the *parties* concerned in it.

¹ Kemmerer : The A. B. C. of the Federal Reserve System, Pages 41-42.

(1) *The Purpose of the Bills* :—As to the purpose for which the paper is drawn it should mainly arise out of a *genuine* trade transaction, that is, it should be drawn for agricultural, commercial or industrial purposes. If this is achieved, there is little risk of losing the money on the part of the Central Bank buying a bill, because, as soon as the trade transaction is completed, payment is obtained. “There is nothing that requires more sleepless vigilance on the part of a banker than to take care that the debts he buys are genuine and not fictitious ones.”¹ It should be *bona fide* debt for work done. “Bankers should be particularly on their guard against buying bills drawn against articles, which are at an extravagant price, in times of speculation.”

(2) *The Maturity of the Paper* :—The maturity of the paper depends upon the nature of the transaction. For instance, if it is for financing transport of ready commodities it may run from 60 days to 90 days, or if it is drawn for agricultural purposes it may run up to 6 or even 9 months. *But if the resources of the Central Bank have to be liquid*, it postulates that the paper should be for a short period, otherwise its money would be locked up for a long time and the Bank would be endangering its function of meeting the demands of commercial banks in an emergency.

(3) *The parties to the Paper* :—The last fundamental to be observed is the solvency of the parties to a given transaction from which the paper takes its birth. Specific information should be obtained regarding the status and business of the parties and particularly of the acceptors, as in this way alone the genuineness of the paper can be guaranteed. “We hold it to be utterly contrary to all

¹ Macleod: *Theory and Practice of Banking*, Vol. II, Pages 421, 422.

sound banking to take bills merely on the supposed respectability of the customer..... Some customers begin by getting the character of being respectable but in course of time their fraudulence is discovered or manifests itself.”¹

A bill of exchange, as we have noted in Chapter II, satisfies in a remarkable degree these requirements, and the Central Bank should aim at filling its portfolio with such bills. It is drawn by a creditor on his debtor for a specific amount of money for commodities given to him on credit, so that the *bona fide* nature of the transaction can easily be detected. Besides, as it has a fixed date of maturity, the Bank is quite sure when the loaned money is to return to it and can therefore adjust its future purchases accordingly. Again, a bill of exchange has the quality of being transferred from person to person by the simple system of endorsement, “so that it provides one of the requirements essential to the assets of a Central Bank, namely, that of free convertibility into cash.”² And in course of its negotiability, if it is endorsed by a recognised bank, this gives the bill the hall-mark of quality.

THE EXAMPLE OF THE UNITED STATES OF AMERICA :—The three principles of eligibility (namely, the purpose of the paper, its maturity and the quality of the parties to it) stated above, are completely enforced and guaranteed by the Federal Reserve Act in America in the discount of paper by the Federal Reserve Banks :—

As for the purpose of the Bills and their maturity the law limits the rediscounts to :—

- (1) “notes, drafts and bills of exchange *endorsed by a member bank or* and arising out of actual commer-

¹ Macleod : Theory and Practice of Banking, Vol. II, Page 423.

² Kisch and Elkin : Central Banks, Page 123.

cial transactions, that is, notes, drafts and bills of exchange issued or drawn for agricultural, industrial and commercial purposes, or the proceeds of which have been used, or are to be used for such purposes ;”

- (2) “and notes, drafts and bills of exchange bearing the endorsement of a member bank and issued or drawn for the purpose of carrying or trading in bonds and notes of the Government of the United States” only. And law definitely *prohibits* the rediscounting of paper which is drawn for trading in securities of *other* countries.

As regards the maturity of the paper it is laid down that it shall be of *not more than 90 days*, exclusive of days of grace, at the time of rediscount.

- (3) A Federal Reserve Bank may discount *acceptances* (defined by law) which have a maturity at the time of discount of not more than *90 days sight*, exclusive of 90 days of grace, and which are *endorsed by at least one member bank* : provided that such acceptances if drawn for an *agricultural purpose* and secured at the time of acceptance by warehouse receipts or other secured documents, may be discounted with a maturity of not more than *six months sight* exclusive of days of grace.

And a very limited amount of such paper is rediscountable with maturities of from six months to nine months.

It will be seen that in order to give a certain security to the paper, American law insists on the endorsement of a member bank before such paper is offered to the Federal Reserve Bank for rediscount. In some countries, for example, Germany and Australia, a minimum of three

signatures, that is, two endorsements and one of the acceptor, is required to make it eligible for rediscount by the Central Bank. With regard to the maturity of the Bills, the Bank charters of various countries generally prescribe the period of three months.

Finally, as regards the quality of the parties to the paper, the Reserve Banks not merely scrutinize carefully such paper but, in order to know the character of the parties well, maintain extensive credit files. "The Federal Reserve Bank of New York alone, for example, has on file statements and other data concerning of 50,000 to 60,000 individuals and business concerns."¹ The keeping of similar files by member banks is insisted on and Federal Banks have staffs of bank examiners who examine the accounts of the member banks frequently.

In some countries, such as Japan and Belgium, special committees, Discount Committees, are appointed by the General Council of the Bank for the scrutiny of bills offered to the Central Bank.

THE CASE OF INDIA :—The legislation drawn up for the proposed Reserve Bank of India for the purchase, sale and rediscount of bills of exchange and promissory notes follows closely the lines prescribed by the Federal Reserve Act of America (to which we have just referred). The Bank shall be authorised to transact the purchase and sale and rediscount of bills of exchange and promissory notes, drawn and payable in *India* and arising out of *bona fide* commercial or trade transactions, bearing *two or more* good signatures, *one of which shall be that of a scheduled bank*, and maturing within *ninety* days from the date of such purchase or rediscount, exclusive of days of grace.

¹ Burgess: The Reserve Banks and the Money Market, Page 28.

In the 'Statement of Objects and Reasons' attached to the Gold Standard and the Reserve Bank of India Bill, 1928, it is explained by the Government that the restriction to scheduled banks of the facilities provided in the Section and elsewhere is intended to give to such banks *some compensating advantages* for the obligation which the Bill imposes upon them to maintain compulsory deposits free of interest in the Reserve Bank.

(2) The same requirements are insisted on in the case of bills or notes drawn or issued for the purpose of financing *seasonal agricultural operations* or the *marketing of crops*, but the signatures shall be that of a scheduled bank or a *Provincial Co-operative Bank*, and the period of maturity in *six months*; but a limitation is put on the amount of such bills or notes rediscounted, which "shall *not* any time exceed *one-fourth* of the total face value of all bills and notes purchased or rediscounted by the Bank up to that time."¹

(3) The Bank shall also transact the purchase, sale or rediscount of bills and promissory notes drawn and payable in India and bearing the signature of a scheduled bank and issued or drawn for the purpose of *holding or trading in securities of the Government of India or a Local Government*, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace.

(4) But the Reserve Bank Bill goes further and empowers the Bank to purchase from or to sell to scheduled banks and persons approved by the Board bills of exchange (including treasury bills) drawn in or in any place in *any gold standard country*, having a maturity of not more than *ninety days* (exclusive of days of grace) from

¹ Refer to the Appendix I.

the date of such purchase and the *keeping of balances with banks in such countries*.

In normal times this provision will not be an unmixed good. On the one hand, it would be of great assistance in financing the foreign trade of India, and in giving the much desired facility by business men ; but on the other hand, if the balances of the Reserve Bank are to be spread out in foreign countries, the object of mobilization of the Reserves in India to help the banks in times of emergency or crisis may be foiled. Besides in abnormal times, such as the outbreak of a War, it would be endangering the safety of the balances to be kept in the belligerent countries.

PART IV.

Advances on Collateral.

It may happen that some customers of a bank, who have no bills to sell, are in urgent need of a temporary loan on security. The banker finds himself placed under a personal obligation to help his long standing customers. He, therefore, takes the promissory note of each, specifying the amount of the loan he requires and the date of its repayment, and also takes into his custody some convertible security as *collateral security* which could be sold off in case the customer fails to pay his debt, and he then makes an advance either in cash or by creating a deposit in his favour. Before an analysis is made of the collateral security, what it is and what it should be, it is important to note the inherent weakness of the mechanism of advances on loan. It is indeed true that when a loan is given a time-limit is prescribed, but this limit is not absolutely fixed and unalterable, and it is the common experience of banks that they are induced by the customers to *extend*

the period of the loan before they have discharged their obligations. Request for a renewal of a loan specifies weakness and difficulty on the part of the borrower to fulfil his original contract, and if the bank succumbs to the request it undertakes additional risk and in case of incapacity on the part of the customer to pay, it is ultimately driven to sell off the securities to recover the money. The advance is a weak feature of banking business because the *purpose* for which it is needed is in most cases *never definitely revealed*, as it is revealed in the case of a bill of exchange. Besides, advances "are barren isolated transactions, which lead to nothing ; whereas a discount account promotes commerce, and becomes more profitable as the business of the customer increases."¹ But the great danger lying behind an advance reveals itself when many such advances are made even to customers in whom the bank has confidence, and it finds that owing to some sudden cause the depositors make a run on the bank. In this case the only resource at the disposal of the Bank to meet its obligations is the sale of the securities of the customers. But these cannot be sold off on the spot and cash recovered to meet the situation. Even if cash is so realised it may happen that owing to market conditions the securities have fallen in price. The advance, therefore, fails in liquidity during a time of stress. In making an advance in the form of creating deposits for customers, the banks must always have strict regard to the quantity of the cash reserve they possess, so as to meet the demand for payment at once and fully. But if the reserves have fallen low owing to an unusual demand, the banks must have facility to *rediscount the promissory notes* in order to be provided with cash.

¹ Macleod : Theory and Practice of Banking, Page 423.

It is just here that a Central Bank steps in to help the banks in improving their cash position. It is ready to advance money to a bank which is pressed for money by rediscounting promissory notes and taking into its custody the Collateral offered to the banks by their customers.

From the nature of the advance and the risks and dangers it involves, it follows that strict regulations must be enforced on the Central Bank with regard to :—

- (a) the period of an advance ;
- (b) the Collateral supporting the promissory notes which it should accept ;
- (c) and the renewal of the loans to the banks.

(a) *The Period of an advance* :—The first requisite necessary is that the advances should only be for short periods. The Federal Reserve Act of America is the most cautious in this respect. It empowers any Federal Reserve Bank to make advances to its member banks for a period *not exceeding fifteen days*. The period at first sight appears to be too brief to be of real usefulness, but in America during particular years they have been the most important form of advance made. In Europe, however, the period generally laid down is *three months*. Although a country like Norway admits the making of advances for a fixed term not exceeding six months, in India the proposed legislation empowers the Reserve Bank to make loans for advances repayable on demand or on the expiry of fixed period not exceeding *ninety days*.

(b) *The kind of Collateral* :—The second requisite for making the loans or advances perfectly secure is that the security which supports the promissory notes should be of *first-class* quality and should be one that could be sold off *easily* and *quickly* and without any loss when the necessity arises for so doing. It should also be paying a fixed

rate of interest, so that its value is stable and not liable to fluctuation like those which give varying dividends.

The proposed legislation in India gives the Reserve Bank the right to make loans or advances on the security of "stocks, funds and securities other than immovable property in which a trustee is authorised to invest trust money by any Act of Parliament or by any law for the time being in force in British India." Evidently this legislation prescribes almost *absolute security* to the Collateral.

As regards other countries, the regulations differ according to their individual conditions. But in Germany the utmost care is taken to make the advance or the loan commercially safe and the law consequently lays down specially the nature of the security and its period of maturity and leaves the Reichsbank to make the advance, "which should be limited to an amount leaving an adequate margin in relation to the market value of the security, as in Belgium, where even the Government securities are only reckoned at four-fifths value."¹ The amount of the advance made is to be only a *proportion* of the market value of a security. This proportion differs with different securities. In Italy the advances to be made by the Bank of Italy on bonds of the Government or guaranteed by them are limited to nine-tenths of market value. This method keeps a safe margin for the Central Bank in making loans.

(2) The second kind of Collateral usually allowed to Central Banks for making advances are drafts, and bills of exchange which are eligible for purchase or rediscount by them. In discussing the nature of a bill it was found that, as it was self liquidating, it was the most desirable

¹ Kisch and Elkin: Central Banks, Page 131.

form of paper for a Central Bank to deal with. Still, in order to limit the amount of advances that can be made even on the security of bills, special regulations have been laid down in the charters of some of the Central Banks. For instance, (a) in the Gold Standard and Reserve Bank of India bill a proviso is laid down that the total of the loans and advances against such bills of exchange and promissory notes payable in India (and with the qualifications imposed on them in the Bill), *shall not at any time exceed one-fourth of the total loans and advances made by the Bank up to that time.*

(b) But the law in Germany is more definite when it authorizes the making of an advance only on condition that its total amount is less than the market value of the Bill. Similarly, in Japan it is laid down generally that the amount of the advance must not exceed eighty per cent. of the market value of the Collateral.

(3) The Charters of various Central Banks permit advances to be made on the security of gold and silver minted and unminted. Gold is world money and is the soundest collateral which could be offered. But the case of silver is different. Its depreciating and constantly fluctuating value necessitates cautious calculation as a basis for security. Such caution is obtained in Italy where the Bank of Italy is permitted to make advances for not more than four months on the security of silver bars *reckoned at not more than two-thirds of current value.* But the best course possible would be to restrict the Collateral to gold. In the legislation of the Reserve Bank of India it is wisely laid down that the security shall be "gold coin or bullion or documents of title to the same."

(4) In India the financing of industry and the movement of crops are at present effected by *cash credits*, which

are a time-established practice. In order that the facility for financing may not be curtailed a provision is made that the Reserve Bank of India may make loans or advances not exceeding ninety days against the security of "promissory notes of any scheduled bank or a Provincial Co-operative Bank, supported by documents evidencing title of goods which have been transferred, assigned, hypothecated or pledged to any such bank as security for a *cash credit* granted for *bona fide* commercial or trade transaction or for the purpose of financing seasonal agricultural operation or the marketing of crops, for a period of *five years* only from the date on which the Act comes into force." Evidently this is a temporary measure which is found necessary. A sudden discouragement to the system of cash credit would possibly dislocate the facility for financing commerce and agriculture. But if the provision is made permanent, it would be objected to on the ground that it would be instituting risky business, because the securities for cash credits are not realisable in times of pressure. (*More about this in Chapters XII and XIII.*)

(5) Most Central Banks are also permitted by Charters to make advances against the security of *foreign* currency or short-dated foreign bills endorsed by a bank, payable in *gold in a gold standard country*. These are valuable assets, being based on gold they possess the quality of liquidity.

(6) Advances are also made by Central Banks in some European countries against the security of *merchandise*. Thus, the Bank of Italy is permitted to make an advance on silks, sulphur and spirits and on certificates of public warehouses under certain special condition. Merchandise or warehouse warrants are also accepted as collateral by the Bank of Japan.

To accept merchandise as collateral is to undertake undue risks. Initially it is an indication of weakness on the part of customers. And a sudden turn in the price of a commodity, even in a foreign country, may influence its price at home. Besides, speculation may also play its part in turning its price. In case, therefore, a customer fails to return the advance made to him, the Bank may find itself a loser in the event of being compelled to realize the advance by the sale of the commodity warehoused. (The subject is discussed with reference to Indian conditions in chapters XII and XIII.)

CHAPTER V

CREDIT POLICY OF A RESERVE BANK
OR CENTRAL BANK

WHAT CREDIT POLICY CONSISTS IN. The principal duty of a Central Bank, and one which is the main reason for its creation, consists in the establishment of its credit policy, which is a conscious and deliberate action on its part. This policy translates itself in those instruments which directly and indirectly aid the Bank to bring about a "*thorough adjustment of the volume of credit to the volume of business.*"¹ This is common sense. Any inadequacy in this adjustment may make the volume of credit either more or less than what is needed by business. If it is more, it will lead to the evil of inflation resulting in a rise in the general price level and foster speculation; but if it is less, it will result in deflation leading to a fall in the general price level and depress business and trade. In short, any maladjustment in the volume of credit to the volume of business brings instability and uncertainty in business and destroys either the creditors or the debtors.

In its *concrete* form, this adjustment of the volume of credit to the volume of business results in the *establishment of an equilibrium in the supply of the reserve funds and the demand for them from the money market.* By raising the price of reserve funds which are needed by business men at a given time or by lowering it at another time as circumstances may require, the Central Bank so adjusts the supply of money to the demand for it that there

¹ Burgess: *The Reserve Banks and the Money Market*, Page 168.

is neither an excess nor a deficiency of the funds needed by the money market and financial stability is maintained. Indeed, no greater responsibility hangs on the Central Bank than that of making its credit policy effective and in so doing it has to be the financial dictator of the money market. In what manner this is achieved shall be the purpose of this chapter to show.

PART I.

The Bank rate of discount.

WHAT IS THE BANK RATE OF DISCOUNT?

The regulation of the rate of discount by the Central Bank is a most powerful instrument by which it exercises control over the money market. Discount is the price charged by a bank for discounting bills and thereby extending its credit to business men ; but the rate of discount charged by a Central Bank is the official minimum rate per cent. charged for discounting first class bills and is called the *Bank rate of discount*. It is to be distinguished from the *market rate of discount* which is the rate charged by the *other banks*. The influence of the Bank rate on the market rate will now be considered, viz., how a change made in the former by a Central Bank results in a corresponding change in the latter. If a rise or fall in the Bank rate brings about a rise or fall in the market rate to the same extent, control of the Central Bank over the money market is successfully established.

EFFECTS OF RAISING THE BANK RATE.

(A) *Direct Contraction of Credit* :—Suppose for some vital cause there is a *drain on the reserves of a Central Bank* and it is found expedient to raise the Bank rate of discount. What would be its effects?

(1) *Borrowing made dear* :—In the first place, a rise in the rate signifies that business men are compelled to pay more for discounting bills than before. And if they are doing business on a large scale but with a *narrow margin of profits* as is generally the case in commercial transactions, a rise in the Bank rate may wipe out that *margin*, and what is an anticipated gain may turn out to be a loss. They are, therefore, dissuaded from presenting bills for discount or from borrowing money. This *diminution of the domestic demand for loans* means that a *check is placed on the extension of credit* until the depleted reserve is made good.

(2) *Market rate tends to rise* :—But a rise in the Bank rate will, sooner or later, lead the banks to raise the market rate of discount. If *there is scarcity of money* this would result almost immediately, because when business men find that by discounting bills at the Central Bank, they have to undergo greater sacrifice, they would get the bills discounted cheaply at the other banks and as the demand for discounting bills increases at these banks, the supply of money being limited, the rate will rise. It will also be raised due to the natural inclination of the banks to make the most of the opportunity presented to them to make profits, and the possible fear of finding their cash reserves falling below the safe margin. But, it may happen that the market rate may not readily respond to the Bank rate. If, for instance, the other banks have abundant funds and have as a consequence little fear of their reserves being endangered, they may continue to discount paper and give loans at a rate lower than the enhanced bank rate ; under this circumstance, as will be noted later, the best instrument to use is the sale of bills and securities by the Central Bank, and also borrowing in the open

market and the consequent withdrawal of funds from the market into the Central Reserve in order to make the money market tight. The process would be continued until the balances at the banks are sufficiently reduced and the market rate is brought into unison with the bank rate.

(3) *Deposits made Dear* :—A rise in the Bank rate also leads to an increase in the price the banks have to pay for deposits, if they feel the necessity of attracting them. And as the banks are compelled to pay a higher deposit rate, they try to make up the difference by charging a higher price for loans offered to brokers, and these latter in their turn would be forced to charge higher rates to business men. And the effect is the same—a rise in the market rate.

(4) *Force the sale of commodities* :—But a rise in the Bank rate curtails not merely the volume of credit, but has a tendency to force the sale of commodities by business men. Finding that they have to pay a higher price for borrowed capital, they prefer to unload their stocks of commodities on the market *at reduced prices* rather than continue to pay a rate which would force them to sell the commodities at less than cost price. The result is a *fall in commodity prices*.

(5) *Force the sale of Stocks and Shares* :—Besides, when the rate of discount is raised, investors find it more profitable to sell off their stocks and shares and invest the proceeds in the discount market. And as the rise in the rate is usually a temporary phenomenon, occurring in an emergency and disappearing after the emergency has ceased, investors are particularly anxious to take advantage of this short-period profitable market for investment. A rush may, therefore, be anticipated

in the sale of securities resulting in a *fall in their prices*.

(6) *Attracts deposits* :—It was stated above that a rise in the Bank rate leads to a rise in the rate offered for deposits by the banks to the public. The new deposit rate is likely to attract more customers and deposits come into the banks in increasing amounts. This, therefore, leads to a preference for investment in deposits on the part of the public over an immediate demand for commodities by them. The demand for commodities in turn falls, leading to a *fall in prices*.

(B) *Help from foreign countries* :—So much for the changes that a rise in the Bank rate directly makes in the domestic economy of a country. It now remains to consider what influences the raising of the rate exercises in attracting help from foreign countries in correcting the situation.

(1) *Exports encouraged* :—The fall in prices of commodities makes the country an ideal market for foreigners to buy from, but a bad one to sell to ; so that exports are encouraged and imports are discouraged. And imports fall off still further because consumers can now buy commodities freely in the home market, as their prices have fallen. The result is that the foreign indebtedness of the country gets reduced and *gold flows into it* instead of the flowing out of it.

(2) *Gold attracted* :—Then again, if the discount rate is raised to, say, 7 per cent. in the country X, (the country in question) whilst it remains at, say, 5 per cent. in country Y, this means that business men in Y will wish to transfer money to X, where it commands a higher price. “The higher the rate, the less is the probability that credits will serve the purpose of money, and the greater the

probability that actual shipments of the precious metals will earn a high rental price.”¹ Thus gold will be shipped from Y where it is cheap to X where it could earn more.

(3) *Exports of gold prevented*:—But not merely will actual gold be shipped from Y to X but it would make profitable the transfer of credits to X. If, for instance, a banker (of country Y) in X is about to ship gold worth £1 million to his head office in Y, expectation of a rise in the rate of discount in X would make him postpone the shipment and invest the amount in X.

(4) *Prices of bills rise*:—Besides, as the rate is higher in X, business men in Y will buy bills on X empowering them to receive so much money in X. The price of bills on X will therefore rise. At the same time, the agents of business houses of country Y residing in X may draw bills on Y and sell them in X. The result will be that supply of bills on Y will increase and their price will fall. The net result is a correction of the foreign exchange in X.

All these effects of the rise in the Bank rate will therefore be a return of gold to the country and the protection of its Reserves. It thus is a means both of protecting the reserves and of putting a brake on excessive expansion of credit.

OTHER CHIEF FACTORS LEADING TO A RISE IN BANK RATE:—In addition to the protection of the gold reserve, which has just been dealt with, there are other factors which necessitate the raising of the discount rate by a Central Bank.

(a) *To prevent speculative excesses*:—When trade is booming so much that *speculative mania* has caught hold of the market, security tends to decrease. But the atmosphere of false optimism leads business men to rush ahead

¹ Conant : The Principles of Money and Banking, Vol. II, Page 223.

into making contracts. Trade becomes intense, the banks on their part demand loans from the Central Bank more frequently and in increasing amounts, and the Central Reserve is in danger of being depleted. To leave the money market alone at this stage would be to precipitate a crisis. It is just at this moment that the Central Bank steps in to control the money market and uses various devices to arrest the expansion of credit beyond the legitimate safe limit, the greatest being to raise the rate of discount.

(b) *Correcting an adverse exchange* :—One of the most frequent occasions on which a Central Bank raises the Bank rate is when gold exchanges move against a country, showing that the export gold point has nearly been reached, or that gold exports are actually taking place. For the reasons stated above, a check is put on the outflow of gold and its inflow is encouraged. Indeed, exports of gold do not always connote an unhealthy condition of the trade of a country or the beginning of a period of financial strain in the money market, but when they follow excessive indulgence in credit expansion or are the results of speculation, the value of raising the Bank rate ought to manifest itself.

(c) *A rise in discount rate abroad* :—It may also happen that gold is moving from the country X to the country Y because in the latter the rate of discount has risen so high as to make it profitable for business men in X to ship gold there and make a clear profit after paying for the cost of transmission. Under these circumstances, in self-defence, the rate may be raised in X.

(d) *The normal drain* :—Yet another event that precedes a rise in the Bank rate is when gold flows to *finance the crops* which are ready for transport. This is a periodical

drain which might well be called normal. In the case of a country like England, holiday payments also lead to a drain on the reserves.

(e) *As an instrument of Government Currency policy* :- Finally, the Bank rate may be raised as an *instrument of currency policy* by a Government which controls the policy of the Central Bank of a country. When, for instance, *economic* causes are working in one direction to *bring down* the ratio of exchange, the Government may try to *bring up* the exchange value of the coin by raising the Bank rate. Such a rise would have the effect of *creating contraction of credit* and an artificial scarcity of money in relation to the real needs of the country. If the supply of money is artificially made shorter in spite of the demand, its exchange value will tend to rise, i.e., there will be a fall in general prices.

And if the raising of the rate is not effective and is supplemented by such devices as the sale of securities or borrowing by the Central Bank, stringency of money must surely result and the rate of exchange prevented from falling to a lower level.

If economic circumstances are combining to lower the rate of exchange and the Central Bank is using devices to prevent its fall, the Bank's aim can only be accomplished at the expense of the business and trade of the country. To create artificial stringency of money in the money market at a time when business men and producers require accommodation is to embarrass them and put an impediment in the way of making and fulfilling contracts. How can new contracts be entered into in the face of a contraction of credit? How can contracts already transacted be fulfilled if producers and business men are compelled to pay more for

borrowed capital? What would be the fate of those who had contracted in the past to buy and sell commodities at certain prices when they find that prices have suddenly and unexpectedly fallen because of the devices used by the Central Bank? The producers are doubly hit. On the one hand, they are compelled to pay a higher rate for borrowed capital, thus raising their marginal cost of production; and on the other hand, a fall in prices wipes out their anticipated margin of profit and forces them either to pile up stocks and lock up their capital or sell off at a loss.

If, therefore, natural forces of trade are trying to pull the rate of exchange in one direction and if artificial measures taken by a Central Bank tend to pull it in another direction, the tug-of-war may temporarily be won by the latter, but the Bank's action would leave behind nothing but ruin in its trail. The Bank would damage its own reputation, destroy all certainty in business transactions, ruin home producers and paralyse the money market of the country.

EFFECTS OF LOWERING THE RATE OF DISCOUNT. It should now be easy to understand the effect of lowering the discount rate by a Central Bank. When *trade is inactive* and there is an abundant supply of money, the bank rate may be lowered. But the lowering of the Bank rate of discount will have an immediate and positive effect on the market rate, which will move in harmony with it.

(a) *Reduction in discount and deposit rates:—The Commercial banks must reduce their rate of discount as well, otherwise their customers will discount their bills more profitably with the Central Bank. But the fall in the Bank rate must soon lead to a fall in the deposit rate,*

because banks cannot afford to pay more for borrowing money than they make by lending it. These factors tend to dissuade business men from doing discount business or depositing money.

(b) *Increase in demand for commodities* :—On the contrary, trade with borrowed capital is encouraged, and demand for commodities becomes brisk, which leads to a rise in their price. Money flows back to the investment market and prices of stocks and shares go up.

(c) *Imports encouraged and gold is exported* :—When prices of commodities have risen, exports fall off and imports are encouraged and the exchange becomes adverse to the country. Besides, a low Bank rate at home is a cheap market for gold for foreigners. They buy the gold and sell it in other countries where the discount rate is higher. They also sell off their investments in stocks and shares at the higher prices and send the proceeds to their respective countries.

A combination of all these factors results in the depletion of the Central Reserve and gold flows out of the country until the Central Bank again raises the rate, thus protecting the Reserve, and gold returns to the country.

OTHER PRINCIPAL FACTORS LEADING TO A FALL IN THE BANK RATE :—The chief factors that lead to a low Bank rate are many, but they are easily traced. As stated above, when there is plentiful supply of money and trade is depressed, on the one hand the security offered is great, but on the other there is little demand for money on the part of business men. Under these circumstances there is plenty to lend but little demand, and the rate falls. It will also be low when a favourable trade balance leads to an inflow of

gold and increases the supply of money and the credit which could be based on it. The same result will occur if money returns to the Central Bank after the periodical financing of the crops. Finally, when the rate of exchange improves the necessity for a high rate tends to disappear.

THE DISCOUNT RATE AND STABILITY OF THE MONETARY UNIT :—It follows from the discussions just stated above that the rate of discount is a most delicate and potent weapon, which, if *judiciously employed*, will bring about stability of value of the monetary unit. For, when there is a drain on the gold reserve and the rate is raised, it leads to restriction of credit and a fall in general prices. Both these diminish the demand for currency, so that the redundant currency will be *returned* to the Central Bank. At the same time *less currency will be issued* by it. But when, circumstances necessitate the lowering of the discount rate, credit will be extended and the general level of prices will rise, leading to an *increase in the demand for currency*. More currency will, therefore, be issued by the Central Bank.

Thus the rate of discount is the principal instrument for establishing a *just proportion* between gold reserves, the volume of credit and of currency in a country, and if this is secured, it will result in the stability of value of the monetary unit.

But it cannot be too strongly emphasized that the economic benefits, which a change in the discount rate is likely to bring, will accrue to a country only if *there is full justification* for such a change in the money market at a given time. Any arbitrary changing of the rate without justification would result in the destruction of the money market.

THE BAROMETER OF DISCOUNT POLICY :—Generally the flow of gold *into* or *out of* the Central Bank's reserves indicates the strength or weakness of the domestic economy of a country. It tells us whether trade and business are flourishing or languishing, whether the credit situation is good or bad, and whether relaxation or imposition of control by the Central Bank is necessary or not. The effects of the working of various economic factors in a country converge in the gold situation at the Central Bank.

It has been the lesson of history that the most important factor leading to a change in the discount rate in European countries has been the position of their *gold reserves*. They have followed the example of the Bank of England by watching anxiously their reserve ratios as a guide to changes in the gold situation. Assuming that other circumstances remained the same and the reserve ratio sank low, they at once raised their rates of discount to protect their gold; and conversely they lowered their rates when the reserve ratio went up. But the experience of that fortunate country, the United States of America, has been in recent years different in this respect. From 1921 to 1924 gold began to pour into the United States at the tremendous rate of \$ 300,000,000 a year, and the reserve ratio has been so far above the legal minimum that it has lost its importance as a guide to discount policy, 'and instead of considering means of attracting gold, it has been necessary to consider means of repelling it'.¹ But this is a temporary phenomenon and when the credit situation in Europe has improved and when the enormous accumulation of gold in the United States has spread over

¹ Burgess: *The Reserve Banks and the Money Market*, Pages 187 and 199.

the world according to the law of demand and supply, the country will have to look to its reserve ratio as the true barometer of discount policy.

OTHER GUIDES TO DISCOUNT POLICY. (a) *Changes in the volume of business and of Credit* :—There are other conditions, too, which a Central Bank considers as a guide to its discount policy. In the first place, a continuous and careful study of *the changes in the volume of business and volume of credit* used in the country year by year has to be made. If both are moving in harmony there is no tendency for the discount rate to change, unless there are other disturbing causes. But if the rate of growth in the volume of credit tends to outstrip the rate of growth in business, it is an indication that credit should be curtailed and therefore the ratio of discount raised accordingly. On the contrary, if the rate of growth in business tends to be greater than that in credit, this prescribes an extension of credit and consequently a lowering of the discount rate to make borrowing easier. But for a careful study of these changes elaborate machinery for collecting information is necessary, such as that established in the United States by the Federal Reserve Board at the end of 1917.

In this system, the member banks in the important cities submit through the Reserve Banks weekly reports of their chief transactions, which help the Board to anticipate more or less accurately changes in the volume of credit. The Federal Reserve Banks themselves do the same and their reports show what changes in credit are expected to take place immediately. Further, the reports of the member banks are minutely analysed with a view to showing the nature of the loans and the quality of the security on which they are based. Besides, the Banks

may be freely buying paper owing to customers having numerous and powerful connections who "can manufacture bills to an incredible extent to cover up losses, and keep themselves afloat by extracting fresh funds from their banks to speculate with ; until when the final collapse comes, it is found their assets are almost all eaten away, and left perhaps a shilling or two in the pound to meet the masses of paper."¹ In short, they may be over-trading. Consequently the papers which the banks buy must be closely scrutinized and reports sent to the Central Bank, so as to enable it to put a brake on the extension of credit.

(b) *Movement of Prices* :—Another guide to discount policy is the observance of prices. A change in the general level of prices in a country tends to indicate disparity between the volume of business and the volume of credit used. If the volume of credit exceeds the real needs of business, it leads to a rise in the general price level, and if it falls below business needs, it leads to a fall in the general level of prices. Indeed, the general price level in a country is affected by many other causes besides this, but if the movement of prices as well as the relation of volume of credit and business are jointly watched, they *indicate whether the storm is expected or not*. But the help given by watching changes in the price level depends on the manner in which the index numbers of prices are compiled and on the efficiency of the Bureau of Statistics undertaking this task.

(c) *Conditions of Production and business* :—It is significant that a Central Bank must also continuously study conditions of production and business in the country in order to prevent the occurrence of a crisis. Credit extend-

¹ Macleod : The Theory of Credit : Vol. II, Pages 709-710.

ed for productive uses may turn out to be excessive. Production may be going on vigorously, employment may be complete, contracts in buying and selling commodities may be undertaken briskly and a spirit of optimism may prevail, but if it suddenly appears that production has outrun consumption, the markets are overstocked, there is over-trading and a crisis begins. Von Stein makes the extension of credit the real cause of business crises. He states: "The cause of this sudden increase of production lies in the rapid increase of productive capital and since this is occasioned by credit, the rapid increase of credit, interest not being considered, is the cause of commercial crises." Thus a boom time in production and trade is frequently also a time of impending disaster, and the authorities controlling credit should not be content to know merely whether credit is extended for productive purposes, but should keep an anxious watch on the volume of production and trade in order to know how far they differ from the trends of the normal growth of past years. The slightest tendency to go above the normal trend should warn the authorities against further extension of credit. Thus the right policy ought generally to be the gradual raising of the rate of discount when business is brisk, and lowering the rate of discount when business is slack. No sooner is credit brought within the tight hold of the Central Bank than the spirit of false optimism tends to vanish and the business community, made to realise the true state of affairs, put a check on their transactions. The successful avoidance of a crisis depends entirely on the soundness of judgment of the authorities and the promptness and vigilance with which they make use of this weapon of discount policy.

(d) *Movement on the Stock Exchange* :—Another use-

ful guide is the continuous observance of movements on the stock exchange. Perverted forms of speculative activity are extremely dangerous to credit institutions. Customers may take loans or over-drafts from banks for the concealed purpose of investing the money in shares of companies which may be temporarily the pets of a ring of speculators. To this evil form of speculation there must be added "the tendency of human nature to overestimate its ability to predict and its power to control the market. Adam Smith remarked upon the overwinning confidence in their own abilities by the majority of men. This observation upon human nature finds an important application in speculation. It is a blind confidence in one's ability to read the markets that furnishes the 'lambs' of the stock exchange."¹ Whatever may be the cause, an extraordinarily large turnover of particular shares in the stock exchange is the danger signal for the whole banking organization of the country. It is for the Central Bank then to raise its discount rate and make credit so dear that no more "lambs" of the stock exchange are furnished for the slaughter.

(e) *Changes in Money rates*:—Observance of the changes in money rates in the market is also an important guide to discount policy. If, for instance, rates are rising when the trade demand does not warrant their increase, the rise is the surest indication of speculation prevailing in the market. This is an occasion for the Central Bank to tighten up its discount rate so as to make borrowing prohibitive and enforce a restrictive policy on the commercial banks. But if rates are found to rise steadily owing to genuine trade demand the Central Bank should prepare itself for greater accommodation to the money market.

¹ E. Jones: *Economic Crises*, Pages 170-171.

Success depends on continued observance of the factors responsible for the changes.

(f) *Credit situation in foreign countries* :—Credit conditions in other countries with which a country trades have also to be considered by the Central Bank authorities in determining their discount rate. If, for instance, the discount rate is raised in a foreign country Y and has reached a level higher than in the country X, gold would tend to leave X for Y to get the benefit, and the drain would not stop until the rate in X was raised sufficiently to cut out this advantage. On the contrary, it may happen that owing to international circumstances, so much gold flows into the country that (as the gold enters into circulation) there is the fear of a serious inflation of prices with its attendant evils, and the authorities may consider it a wise policy to reduce the rate of discount in order to repel gold instead of attracting it. Then again, during certain months of the year 1929, economic conditions in the money markets of certain European countries demanded low rates of discount. But during that time the gambling mania had overtaken New York and fantastic money rates had lured millions of European gold to America, so that actually, to save their gold, the Central Banks of these European countries were forced to raise their rates of discount. Consequently, it is imperative that credit conditions of other countries should also be a guide to discount policy.

(g) *Needs of the Government* :—Another urgent factor is the budget situation of the Government, which the Central Bank must watch. As the Bank is the sole agent for the Government, it may find its discount policy affected by any unusual and urgent capital expenditure on behalf of the Government. For instance, a loan may

have to be floated when in the interest of the money market actually some expansion of currency is needed. Such a loan issue might result in virtual contraction of currency which would lead to higher interest rates and do harm to the money market. Besides, the rate of interest at which the loan is issued might also influence the discount policy of the Bank. Thus, the terms of the loan, the interest it bears and the time when it is to be issued have great effects on the rate of discount of the Bank, whose authorities must not merely consider the present conditions of the money market but must be able to forecast pretty accurately its needs in order to advise the Government on the success and popularity of the loan. But during extraordinary times it becomes impossible for the Central Bank to estimate the wants of the Government.

In emphasizing the effects of Government needs on the credit policy of Central Banks Dr. Benjamin Anderson, Economist of the Chase National Bank of New York, said in his address, "We saw the conflict between sound banking policy and public finance during the War. At a time when sound banking policy called for steeper money rates, the policy of the Treasury called for cheap money. At a time when the Government as a buyer wished to control and limit credits of those who were producing peace-time goods, so that labour and capital might be more readily diverted to the production of war supplies, the Treasury insisted on easing money throughout so that it might easily float its loans. Central Bank expansion based on low re-discount rates and the purchase of short-term Government securities, eased off the money markets making it possible for the Government's competitors as well as the Government to borrow cheaply."¹

¹ Chase Economic Bulletin: 23rd March, 1925.

Thus owing to complications of public finance, systematic policy becomes impossible.

CONCLUSIONS :—The above factors which the Central Bank authorities must consider in deciding their credit policy suggest how difficult, delicate and intricate the problem of discount rate is. There is the possibility, for instance, of one factor requiring a lower rate of discount, and simultaneously another factor necessitating a higher rate of discount, and then the decision as to the rate becomes an extremely complex problem. No single phase of the discount rate should be studied in isolation, for if that were done the result would be misleading and, far from meeting the needs of the money market, do harm to it. The goal of the discount policy is the *adjustment of the total amount of credit in the country to the total amount of credit needed by it*. But a correct adjustment depends on those who control the machinery. A *correct observation* of the action of certain forces in the present; *clear foresight* regarding their tendencies in the future and *promptness and vigour of action* are the essential virtues needed in the authorities who mould the destiny of the money market. A discount policy brings the maximum benefit to the country only if in its execution it is *preventive*, not curative. Finally, the discount policy should aim at *national* interests and subordinate all special interests to them. On the other hand, the success of the credit policy depends on the fiscal needs of the Government. Dr. Benjamin Anderson said before the Chase Society “By what accident and fortuitous set of circumstances would it come about that the fiscal needs of the Treasury would uniformly coincide with the needs of commerce and industry? Why should the policy of the Government as to borrowing and repaying be guided by

the commercial situation? What public treasury has ever willingly subordinated its fiscal needs to the other factors named? What guarantee is there, moreover, that the individuals managing the currency, credit, price and foreign exchange situation will all be 'Orthodox' in their theories of money, price etc.?"¹ Under such limitations, then, a sound policy is unobtainable.

PART II.

Open Market Operations.

So far the discount and loan operations of the Reserve Bank have been considered in connection with the other banks. These operations will now be treated in relation to the market directly.

WHAT ARE "OPEN MARKET" OPERATIONS? What are "open market" operations? They relate to the dealings of the Central Bank *directly* with the market and not through the commercial banks—*the direct purchase and sale of bills and securities in the market.* On first thought it would appear that the Central Bank should not do business directly with the public, for it would then be a serious rival to the commercial banks. The public would be easily attracted to it because of its reputation as the premier bank of the country, and on account of its great resources it could offer them better terms than the commercial banks. But the making of profits is not the principal object of a Central Bank undertaking open market transactions. If that were so the objection would hold good. But it does this business under great restraints. It enters the market primarily to give accommodation to business and commerce and in so doing *exercises great influence over the credit situation of the country.* But in what respects and how is this

¹ Chase Economic Bulletin: 23rd March, 1925.

done? The influence is to be traced in the effects produced by the purchases and sales of bills and securities by the Central Bank directly in the market. The economic function is as follows :—

(a) *Effects of the purchases* :—When the Central Bank purchases bills or securities in the open market the (1) immediate result is that money leaves the vault of the Bank and enters the market. The stringency existing in the money market tends to be removed and money becomes *easy*. (2) But those who have sold their bills or securities to the Central Bank deposit the money obtained thereby in the commercial banks. As soon as the deposits with the banks increase, they must by law deposit a fixed percentage of them with the Central Bank.¹ When this has been done, the reserve deposits of the banks with the Central Bank increase, and form a *backing* for a *considerable extension in the volume of credit by the banks* far greater than their cash value.

The net result, therefore, of the purchase transaction is threefold :—

(i) Not only does it increase the investment of the Central Bank but (ii) it removes stringency of money and (iii) enables banks to increase substantially the volume of credit in the money market.

(b) *Effects of the sales* :—But when the bills and securities are sold by the Central Bank they are paid for by the buyers in cheques or cash, so that, (1) money tends to be withdrawn from the market and enters the vault of the Bank. Consequently, the sales result in contraction of money in the money market which tends to become *tight* and in turn leads to contraction of credit. (2) When the Central Bank receives cheques drawn by the buyers

¹ As in the Federal Reserve System of America.

on their banks, the reserve deposits of these banks are debited to that extent. Consequently, as their reserve of deposits with the Central Bank is reduced, their *lending power is curtailed considerably*. This results in a considerable contraction of credit.

But a depletion of the reserve deposits would also lead the banks to make up the deficiency, and for that purpose they may be indirectly compelled to sell bills or securities or use other means to collect cash so as to raise the reserves to their original level. Consequently the sales would lead to a withdrawal of cash from the money market, and still greater contraction of credit would take place, and a tighter money market would be the result.

AN AUXILIARY TO THE DISCOUNT RATE :—The sale operation also works as a great auxiliary to the discount policy of the Central Bank. Suppose, at a particular time, on account of some adverse circumstance such as an excessive outflow of gold or wild speculation resulting in rising prices, the Central Bank finds it expedient to curtail credit and raises the rate of discount accordingly. The rate to become effective necessitates full co-operation on the part of the other banks. It may, however, happen that the banks have abundant cash, and not being in need of money from the Central Bank, they may continue to give loans at a rate lower than the discount rate of the Bank. The efforts to make the discount rate effective would thus be foiled. Under these circumstances an effective weapon in the hands of the Central Bank is the sale of bills or securities in the open market. This would have the desired effect, as noted above, of tightening the money market and raising the market rate to the rate of discount.

Open market operations, therefore, not only enable a

Central Bank to earn remuneration but also to control the credit position of a country, and give it the means to make its discount rate effective.¹ It follows that open market operations should be executed by the Bank with the utmost care and unselfishness. The making of profits should be an entirely subsidiary aim, and regulations should be made limiting the operations of the Central Bank to its principal aim of credit control.

Generally, Central Banks are empowered to deal with the market directly, the chief object being the stabilization of the money market and the control of credit. The Bank of England and the Federal Reserve Banks of America are typical instances. The former, by its dealings in the open market, has been a constant source of stabilization of the money market.

In America special importance is attached to open market operations where a Committee called, "the Open Market Investment Committee," has been instituted and controlled by the Federal Reserve Board. The duty of the Committee is to devise and recommend plans for the purchase and sale and distribution of the open market purchases of the Federal Reserve Banks subject to the principle that "the time, manner, character, and volume of open market investments purchased by Federal Reserve Banks be governed with primary regard to the accommodation of commerce and business, and the effect of such purchases or sales on the general credit situation."

AS REGARDS INDIA :—As regards India, the proposed Bill gives authority to the Reserve Bank of India to purchase, sell or discount in the open market any

¹ "Aside from operations as matters of general credit policy, purchases and sales of securities are made at times to stabilize the money market against unusual temporary disturbing influences such as, Treasury tax-day operations or gold movements."

Burgess: *The Reserve Bank and the Money Market*, Page 229.

bills of exchange or promissory notes drawn and payable in India and arising out of *bona fide* commercial or trade transactions bearing two or more good signatures and maturing within ninety days from the date of such purchase or discount, exclusive of days of grace. This power to deal in the open market is subject to the *opinion of the Board* that it is necessary or expedient that such an action should be taken in *the interests of Indian trade or commerce* or for the purpose of enabling the Bank to *perform any of its functions* under the Act. Thus, action could be taken only if it is approved by the Board and its *purpose* is primarily in the interest of commerce and trade with due regard to the credit policy of the Bank.

The necessity for restrictions on the open market operations of the Bank arose out of an apprehension on the part of various business men. If the Bank were allowed a free hand, they thought, it would be a serious rival to commercial banks whose interests would consequently suffer.

Power is also given for the purchase and sale of Government of India securities which may be of any maturity, and of securities of a local authority in British India which must mature within ten years from the date of purchase. But a limit is prescribed for this transaction. The amount of such securities held at any time in the Banking Department is *limited*. The principle underlying it is that the total amount of securities is *made to vary* in proportion to the liabilities of the Bank according to their different periods of maturity.

Thus, as in the case of the Federal Reserve Banks, careful regard will be given by the Board to the time, manner, character and volume of open market operations. But if, instead of the whole Board functioning in this con-

nection, a special Committee were instituted similar to the Open Market Investment Committee of the Federal Reserve system, greater accuracy could be obtained in gauging the time, character and amount of the operations and the apprehension of the public regarding them would be more completely allayed.

PART III.

Accommodation to Banks (or Credit to Banks).

Another way in which the Central Bank is able to give expression to its credit policy and control the money market is the manner in which it gives credit to other banks. There are two principal methods of dealing with commercial banks by the Central Bank : (1) The *direct* method of the Federal Reserve System of America and (2) the *indirect* method exemplified by the Bank of England.

| Direct Method | Indirect Method |
|---|--|
| Business Men ↓ Member Banks ↓ Federal Reserve Banks | Business Men ↓ Commercial Banks ↓ Bill Brokers ↓ Bank of England |

In the English system, the commercial banks do not borrow money in ordinary times directly from the Bank of England, but when borrowing is found necessary, they do so through their possession of Treasury Bills, bankers' bills and loans to bill brokers, who borrow from the Bank of England on the security of bills or sell the bills at the discount rate. Necessarily the rate at which the British commercial banks lend money to their customers is higher than the discount rate of the Bank of England.

But in America, the general method followed by Banks is to borrow *directly* from the Federal Reserve Banks, using Government securities or commercial paper as collateral. Since the constitution of the Reserve Bank of India is to be based on a modified form of the Federal Reserve system, it is advisable to deal with this direct method of borrowing by banks. There are certain fundamental principles which have been laid down in the Federal Reserve Act as regards the conditions under which member banks are given advances and accommodation by the Reserve Bank and these have been very cautiously guarded by the Board and put into practice.

(1) In the first place, it is the accepted general principle that "the funds of the Federal Reserve Banks are primarily intended to be used in meeting the *seasonal* and *temporary* requirements of members and continuous borrowing by a member bank as a general practice would not be consistent with the intent of the Federal Reserve Act.¹ Thus, the funds are not intended for capital uses and can only be given out for very short periods ; so that their safety is assured. Mr. Burgess states that the average maturity of loans was about eight days.

(2) Secondly, it is also stated in the Act that the Board of Directors of a Reserve Bank shall "extend to each member bank such discounts, advances, and accommodations as may be *safely* and *reasonably* made with *due regard for the claims and demands* of other member banks".

(3) And thirdly, in order to prevent the misuse of the borrowing facility provided by the Act, the Federal Reserve Banks employ *methods* of examining closely and continuously the conditions and methods of business and finance and the position of each member bank, and a

¹ Burgess : The Reserve Banks and the money market, Pages 232-233.

special inquiry is instituted in the case of a bank which is continuously in debt for an unreasonably long period. A maximum limit is also prescribed for borrowing by a member bank.

Thus, the member banks are prevented from making an unreasonable use of Federal Reserve Funds by all necessary restrictions : (a) by providing a sound method for continuously scrutinizing the nature of the business done by a borrowing bank and (b) by putting a rigid limit on the amount and period of the loans. The advantages derived are great. Not only is the nation's money well protected, but as the member banks are compelled to do business on economic lines, if accommodation is needed by them in times of need, their own liquidity and the safety of the depositor's money are assured. The Reserve Banks have to do impartial service to member banks and always regard the public interest as their true line of policy. The method of examination of accounts has a great educative value in forcing on member banks a sound method of banking. Besides, the Reserve Banks serve their most useful purpose as Bankers' Banks in time of emergency, and with the various restrictions on borrowing from them by member banks, they are in a position *to adjust the volume of credit to the volume of business*. Consequently, the direct dealing of member banks with the Reserve Banks becomes an intimate and personal transaction between them and thereby is an auxiliary to the establishment of the credit policy of the Federal Reserve Banks. A direct knowledge of the inner working of the member banks and their constant and intimate contact with the Reserve Banks give the latter greater and more successful control over the volume of credit than other instruments would permit them to obtain. If then,

in the case of India, such a relationship is established by statute between the scheduled banks and the Reserve Bank, it would help to build up a sound banking organization in the country.

PART IV.

A Central Clearing House for the Country.

Another instrument of credit policy would be the establishment of a Central Clearing House managed and controlled by the Central Bank. Like the stock exchange, some form of control over banks can be exercised by a Clearing House. The cardinal rule of a stock exchange is that it does not recognise in its dealings any other parties than its own members. It, therefore, exercises direct control over the business conducted by its members by laying down rules subject to which the member can do business. Its members are definitely forbidden to do certain kinds of business on pain of becoming liable to expulsion. It also controls, although in a less degree, business companies by admitting or rejecting transactions in their shares.

Similarly, a Central Clearing House managed by a Central Bank can be made a very useful institution for controlling the banks of the country. No bank can either rise to first-class rank or obtain the economic advantages of clearance without being a member of the Central Clearing House. It is to the bank's advantage to be an active member, for then alone can it have the opportunity to present in self-defence all its claims on other banks as against their claims on it.¹ The consciousness that other banks will present their demands on it as quickly as possible makes the bank itself act in the same way, and the quickness with which the checks are mutually presented

¹ Dunbar : The Theory and History of Banking, Page 71.

acts as a strong restraint on credit expansion by individual banks.¹ Admittance to such a Clearing House will be a privilege not easy to obtain and unless the bank is prepared to follow the mandate of the Central Bank, as regards the nature of the business which it shall undertake and the credit of the parties to a transaction which it shall accept, it should not be admitted to the Clearing House.

Besides, it is in the Clearing House that the authorities of the Central Bank can detect through the cheques drawn by various parties the intrinsic quality of the business transacted by the banks. Excessive expansion of credit on the part of the banks generally can only be avoided by the enforcement of a restrictive loan policy. But if a bank extends its credit imprudently, that fact can be detected in the Clearing House by the demands for settlement made upon it by other banks. If it is found that during a particular period a bank has always had to make payments to others instead of receiving from them, its affairs would at once be the subject of close scrutiny by the Central Bank. A threat of expulsion from the Clearing House would itself be enough to set a bank right in its dealings, for no bank would prefer to face expulsion, as such a step would bring about a catastrophe by damaging its credit. (See Chapter VI for details of the Clearing House function.)

PART V.

Wise Legislation.

The duty of the State in enacting wise laws to regulate the currency and banking systems is becoming every day

¹ "The prompt presentation of cheque for payments", states Professor Dunbar, "is therefore the established practice, implying no jealousy, hostility or suspicion on the part of the creditor bank—being in fact the natural disposition to be made of an instrument of credit intended to be but short-lived". *The Theory and History of banking*, Page 71.

more important in the economic interests of a country. No Reserve Bank can make its policy effective without the existence of such laws. In the adjustment by the Reserve Bank of the volume of credit to the volume of business such legislation is imperative. For instance, if adjustment is to be brought about during the normally busy season, legislation should lay down adequate rules for making currency *elastic*; then alone will the business community feel assured that they can obtain money through the Central Bank to carry on their operations successfully on presentation of proper securities by them. Currency legislation should also make provision to empower the Central Bank to give elasticity with proper safeguards in the case of a serious emergency. 'A crisis,' writes Professor E. D. Jones, 'emphasizes the primary importance of elasticity.'¹ But it can only be averted if the Bank is permitted to use the means at its disposal quickly and in full strength.

Legislation framed for the organization and working of banks should prove an useful instrument for the enforcement of the credit policy of the Central Bank. Generally, legislation should be concerned with :

- (a) the enforcement of the financial responsibility on the shoulders of the directors of the banks ;
- (b) making certain kinds of business penal ;
- (c) the submission of regular and clear accounts ; and
- (d) the official examination of accounts.

Of these concerns, the first alone needs emphasis here as the others have been dealt with previously. It is not uncommonly found, as in many joint stock concerns, that men of prominence are induced to become directors of banks although they have not staked much financially and

¹ Economic Crises : Page 106.

have little interest in them. This is done to create confidence in would-be customers, who are tempted to do business with the banks. These sleeping directors do not care to take an active part in the management, and the financial interests of the numerous depositors and shareholders are in practice governed by one or two directors. To this may be added the inherent weakness of joint stock principle and of the law of limited liability. On the one hand, stock holders in practice find it difficult to control the directors effectively or else care little to do so. On the other hand, as the liability of the directors is limited to their stock holding, the financial position of the depositors is not safeguarded completely. Legislation should, therefore, enforce greater financial responsibility on the directors by making them liable to depositors for an amount which is equal to the capital stock of the bank.¹ Thus, if the capital of the bank is Rs. 50 lakhs and there are 10 directors, each of them should be made liable for 5 lakhs. In this way alone figure-heads will be prevented from nominally controlling the working of banks and efficiency and morality in management will be assured. But this is not a sufficient safeguard. In order to prevent the management from becoming automatic and to enable the shareholders to exercise their control effectively, the voting power of shares must be limited. This can be secured in various ways. Thus, (1) a schedule may provide that with an increase in the number of shares a person possesses the voting power must decrease ; (2) a limit must be placed on the maximum of the votes that an individual can give and (3) special representation can be provided for the minority.

Adequate bankruptcy law would also assist the Central

¹ Jones : Economic Crises, Page 110.

Bank in keeping control over credit. Filing a schedule in insolvency has, at present, become an easy means for the debtor to take senseless risks in business and to coerce the creditor into extending further advances and thereby committing himself to unsound business. Bankruptcy law should, therefore, be made severe and its most important aim should be to discourage insolvency as a means of retreat.

The contrivance used by a dishonest speculator is to borrow money for investment from a person, say X. Finding that there is no gain in the transaction and that he is compelled to meet his obligation, he borrows from Y and pays X for a part of his claim, and finding himself again in the same difficult circumstances borrows from Z to pay Y, and this vicious process continues until the stage of bankruptcy is reached, when he finds an easy access to the law court to declare himself insolvent. Such malpractices should be made punishable by imprisonment and bankruptcy enforced in the initial stage of the business.

PART VI.

Elaborate Statistics.

None the less important will be the help given by statistics to the Central Bank in reaching its decisions regarding credit policy. A comprehensive range of data covering various departments of the economics of a country supplied to the Central Bank authorities is an invaluable guide not merely for taking immediate action as a corrective but for anticipating more or less correctly future events and taking precautionary measures. In collecting this information concerning business and credit conditions, help can be obtained from various sources. (1) In the first place,

the Reserve Bank itself must have a special department of statistics to collect the information from original sources. In this respect no other country has greater claims to admiration than the United States of America. The data collected by the Statistical Departments of the Reserve Banks contain almost all the facts and figures necessary for controlling credit policy. For instance, from the information so collected "the Reserve Board and Banks compute a variety of indexes, including indexes of prices, production, employment, wages, building, transportation, volume of trade, bank debits, velocity of deposits, wholesale trade, retail trade, failures, etc."¹ To these are to be added current reports on money market rates and conditions, commercial paper outstanding, gold movements, movements of funds about the country, conditions of foreign banks of issue, money rates at home and abroad, foreign exchange rates and several other subjects. This information does not remain within the walls of the Reserve Banks as their monopolistic privilege, but is made public in the form of weekly and monthly reviews together with a complete and exhaustive account of the transactions of the Reserve Banks themselves. (2) Secondly, it is the right of every citizen in a modern state to demand a well developed and complete statistical bureau. The Government can by virtue of its authority compel various institutions and persons to supply information which is denied to the public and to the banks at present. But the information so collected will have little economic value unless it is exhaustive and is promptly and regularly made known to the public, instead of being used merely as a guide to the financial policy of the Government. In no country is there greater necessity for enlarging the

¹ Burgess: The Reserve Banks and the Money Market, Page 176.

scope of Governmental statistics than in India. If the organization of statistics in India is compared with that in the United States of America, it can be said without fear of contradiction that a statistical bureau worthy of the name has still to be set up in India. Not only has its scope to be widened considerably and cohesion brought about in various reports, but the information has to be disseminated in the principal vernacular languages in a form simple to understand, and at a time and in a manner useful to business men. It is no use crowning the banking organization of India with a Reserve Bank without establishing a competent statistical department to provide it with the information necessary for its utility. (3) Private enterprise, too, can be enlisted to secure information. Organizations such as stock exchanges, chambers of commerce and trade, associations of producers, commercial agencies can render invaluable service to the Central Bank by supplying it regularly with detailed information in their respective spheres. In order to help these organizations to do so, men trained in statistics are necessary. Institutions like the Sydenham College of Commerce and Economics can, by making statistics a compulsory subject, help to produce young men well equipped with the knowledge and practice of statistics who would be the chief instruments in collecting and arranging information. Likewise, more trade papers are needed and journalistic schools should be established to train young men to become editors of economic and financial periodicals. With apologies it can be stated that at present there are very few journals in India, both in English and vernacular, which have editors versed in economics to enlighten the business community with a true perspective of business. True, newspapers also suffer from the want of a

correct and exhaustive statistical bureau, and what the public really have from their pen is annually a first class critique of *past* events summarized in Government reports such as "India in 1928-29". But they have no ground-work on which to forecast or suggest the trend of events in the *near future*.

CONCLUSION :—But in order that all these institutions, whether public or private, should work in co-operation to supply the Reserve Bank with the factors on which it can base wise decisions as to its policy, there needs to be awakened a sense of social service on behalf of a national institution. That aloofness and secrecy which mark the transactions of various business institutions should give place to a determination to co-operate fully with the Reserve Bank in establishing financial stability, since it would eventually be to their benefit to do so.

PART VII.

The Management of the Bank.

The most important requirement for the success of the credit policy of a Central Bank is the *constitution* of the Bank and the Board which manages it. Men can make or mar the Bank, and everything depends on the method of selecting the fittest men to constitute the managing body. Since the subject is dealt with in a separate chapter, it shall be the object of this part to suggest general principles.

In the first place, the constitution of the Bank shall be such that every class of people shall have *complete confidence* in it. This can be secured in various ways, *each of which will vary according to the political and economic circumstances of a country*. For instance, it may take

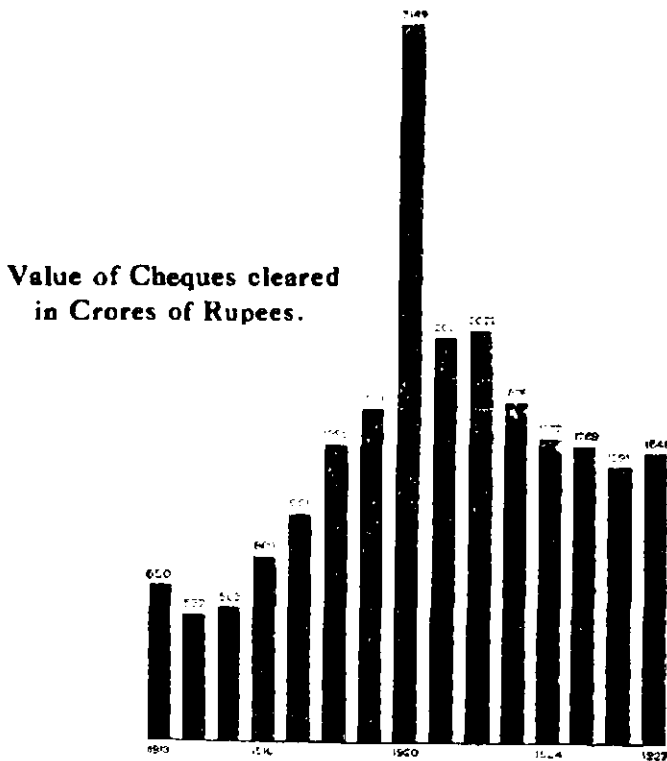
the form of a State Bank owned and managed by the State as in Australia, or it may have the shareholders' constitution as in England, or the constitution of a Bank or Board owned by other banks of the country but controlled by the Government as in the United States of America. A form suited to one country need not necessarily suit another, for its political institutions may be different. However, whatever the form, the principal requirement which it shall fulfil is *to inspire the complete confidence of the nation*. There should not be the slightest suspicion in the public mind that the structure of the Central Bank is such as to go against the nation's interests either directly or indirectly. Secondly, since the Bank is a national institution, the various interests of the country should have fair representation on its board of management. Thus, agriculture, commerce, industry, finance and transport should have their representatives on the Board and others, such as mining, insurance, etc. may also be provided for, if any of these form an important part of the national economy. Besides, the very nature of the Central Bank suggests that care should be taken to establish the balance of power among the various interests, business as well as Government, so that *business interests constitute the majority of the Board*.

Thirdly, in order to ensure that decisions should be arrived at in the most impartial way possible and in the interest of the nation, these representatives should be men possessing not merely a wide knowledge and experience of the economics of their own country but who, by their integrity and independence, have won the confidence of their constituents. (See Chapter XVI for a detailed Constitution.)

CHAPTER VI

CLEARING HOUSE FUNCTION

When the Central Bank has the custody of the balances of the banks of a country, it follows as a natural consequence that it can serve the purpose of a Central Clearing House in the most economical and useful way possible. Before stating how the function is performed and what benefit a country derives from it, we shall show the defects existing in the present method of collecting and clearing cheques in a country like India which has no Central Bank.



Total amount of Cheques cleared from Clearing Houses in India in each year.

In India, there are only 7 cities in which Bankers' Clearing Houses exist, namely, Bombay, Calcutta, Madras, Karachi, Cawnpore, Lahore, and Rangoon.

The returns of these Clearing Houses during the fifteen years beginning with 1913, (the Pre-war year,) are shown in the preceding diagram.

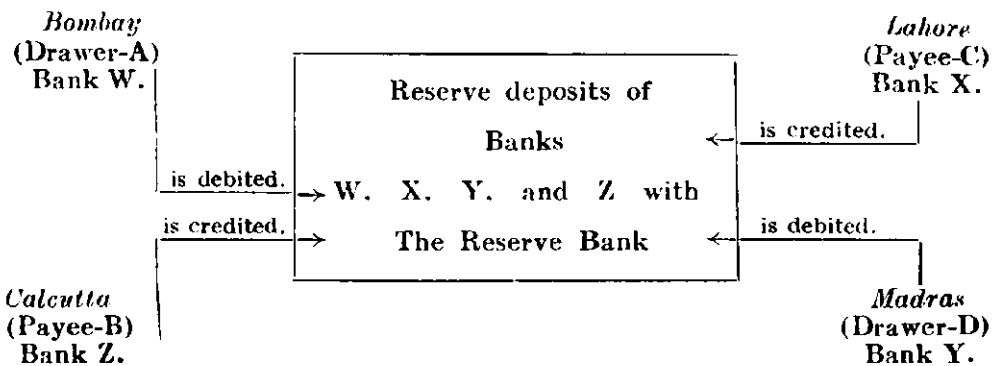
The diagram shows a steady decrease in the Clearings since 1920 with a slight increase in 1927 as compared with the preceding year.

DEFECTS OF COLLECTING AND CLEARING CHEQUES IN INDIA :—But even these few Houses clear cheques payable *locally* only, and cheques payable by a bank in any town *outside* these cities have to be collected there. Consequently, business men have to undergo various inconveniences and expenses. If, for instance, a cheque on the Allahabad Bank, Nagpur branch, is presented for collection at the Navsari branch of the Bank of Baroda, it takes nearly three weeks before the depositor is allowed to draw against it. The customer is thereby prevented from making use of the money for that period. If, however, he is known intimately to the bank and is in urgent need of money, he may be allowed to draw against the cheque before it is collected. But in that case the bank itself loses the use of the money represented by the cheque and charges the depositor interest on it. And if the cheque has to be sent to some towns or cities before it is collected, the greater the delay. This in turn not merely increases the amount of interest to be paid by the payee but increases the *risk of non-payment* of the cheque by the drawer also. The risk of non-payment involved in the delay often leads many business men to refuse cheques on certain out-station banks and to insist on cash payment.

Moreover, if the paying bank has to transmit actual cash to Navsari, it must cover the expense of so doing and would consequently charge for transmission, deducting the charge from the amount paid for the cheque. This charge the payee would have to bear. Whenever, therefore, a bank receives for collection a cheque on another bank with which it has no direct relationship, this charge becomes a customary levy on the payee.

All these difficulties have proved to be great impediments in the way of the development of the cheque habit in India. These evils can best be removed by the institution of a Reserve Bank which would not merely serve as the Central Clearing House for the country, but also establish a country-wide system of collecting and clearing cheques by the establishment of a network of clearing houses under its control and guidance.

HOW A RESERVE BANK WILL SETTLE CHEQUES :—A few simple examples tend to emphasize its working and its importance. Suppose, for instance, A in *Bombay* has drawn a cheque on his bank W in the same city in favour of C in *Lahore*. Similarly another person D in *Madras* has drawn a cheque on his bank Y in favour of B in *Calcutta*.



Then, since the Reserve Bank would be the depository of the balances of all banks in the country, it would serve

as an ideal mechanism for collecting and clearing these cheques issued from one distant part of the country to another.

As the preceding simple diagram explains, when C presents the cheque to his bank X, it gives him credit and passes the cheque on to the Reserve Bank which credits the account of bank X and debits the account of bank W. Similarly when B presents the cheque to his bank Z, it gives him credit and passes the cheque on to the Reserve Bank, where the account of Y is debited and that of Z is credited.

Consequently, (a) by means of a simple *book-keeping entry*, the accounts of four different banks situated in four different centres of the country could be settled *smoothly and quickly*. And (b) the balances of the banks would not merely lie idle with the Reserve Bank to serve their primary purpose of reserves against deposits, but could be constantly used as funds to settle the clearing accounts of various banks in the most economical way.

COLLECTION OF CHEQUES BY A RESERVE BANK AS BETWEEN A CITY AND AN OUT-STATION :—Another example will illustrate the mechanism for the collection of cheques as between a city and a mofussil station, where a Reserve Bank is established. Suppose a business man X in Ahmedabad draws a cheque on the Navsari branch of the *Bank of Baroda* in favour of Y who is a business man residing in Delhi. Then the collection will take the following form :-

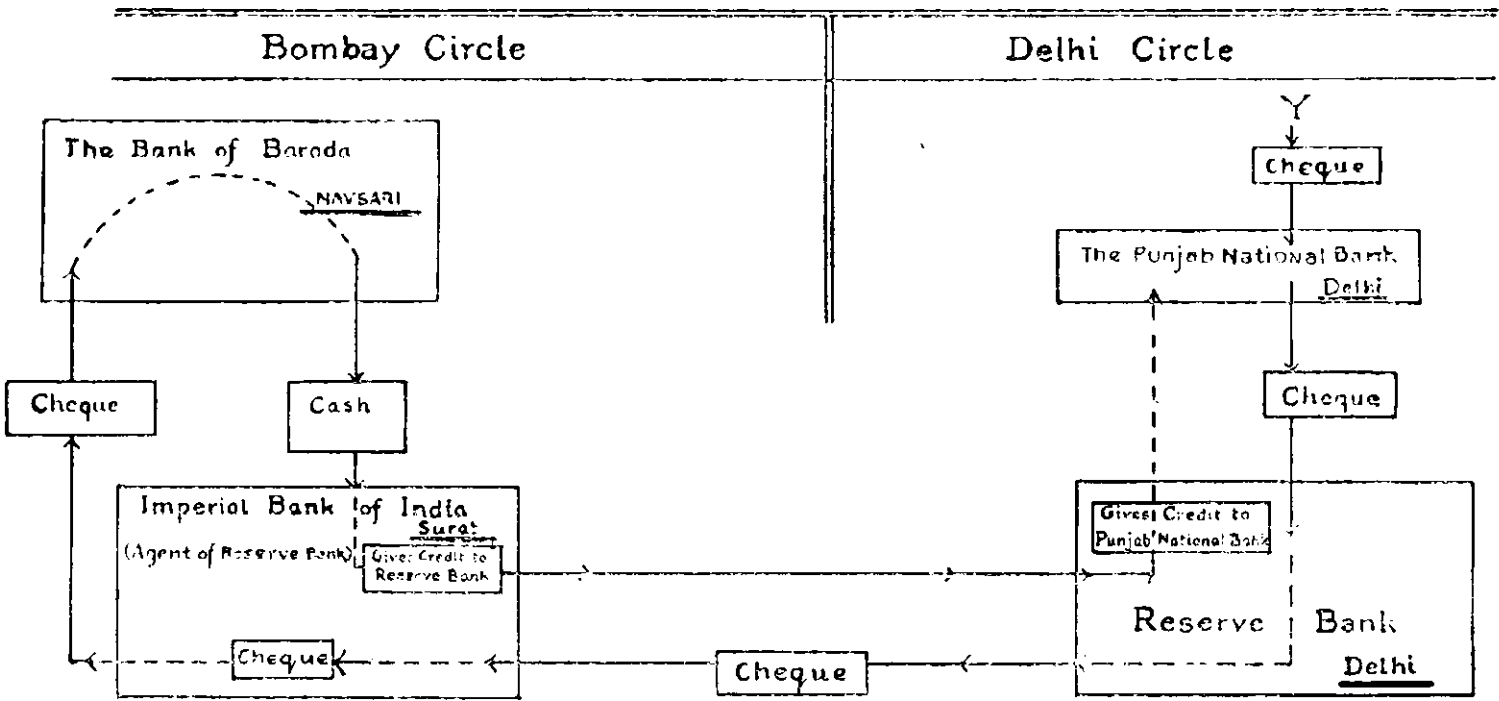


Diagram illustrating the collection of cheques by a Reserve Bank as between a city and a mofussil station.

As illustrated in the above diagram, Y sends the cheque to his bank, the Punjab National Bank at Delhi, and the

latter sends it to the Reserve Bank in the same city. The Reserve Bank immediately despatches it to its *agent*, the Imperial Bank of India at *Surat* for collection, because it is the nearest station (only 17 miles) to Navsari.

On receipt of the cheque, the Navsari Branch of the Bank of Baroda settles with the Imperial Bank of India at *Surat* quickly in either of two ways : (a) it remits cash or (b) gives credit to the Reserve Bank. Immediately on this settlement being made, the Imperial Bank of India gives *credit* to the Reserve Bank and the latter gives credit to the Punjab National Bank.

(A) *Benefits to business men* :—This operation, therefore, has various advantages. In the first place, (1) the actual transmission of currency over a long distance from Navsari to Delhi is avoided and is replaced by the mere transmission of a message of credit from *Surat* to Delhi. Y is thereby saved the deduction on account of transmission charge.

Besides, (2) time is saved by the operation. The Imperial Bank of India, the Agent of the Reserve Bank, receives either cash or credit from a *short distance*, so that the settlement takes very little time and if the amount (or credit) received is large, it would give credit to the Reserve Bank at Delhi by telegram, and more time would consequently be saved. And as the operation takes a more *direct* course, it is by its very nature a saving of time.

(3) As time is saved, the business man receives cash quickly and is thereby enabled to continue his business transaction rapidly. And if he is compelled to draw against the cheque before it is collected, his interest charges are reduced. Besides, the risk of loss through non-payment of the cheque is also lessened.

The above example illustrates the direct benefits which a single business man will receive. But when we consider hundreds and thousands of business men dealing in cheques, the saving to the country would obviously be enormous.

(B) *Benefits to Banks* :—Apart from the benefits which accrue to the individuals, the gain to the banks must also be emphasized. The system of mutual settlements reduces the pressure on the cash balances of the banks, which are thereby in a position to carry on business with *smaller cash reserves*. And the effect of this on the credit situation is direct. The banks are enabled to *extend greater credit* with resulting gain not merely to themselves but to business and trade.

With the institution of a Central Clearing House controlling other clearing institutions spread over the country, *encouragement would be given to the use of mofussil cheques*, because by the removal of the difficulties for collection, they would gain recognition as an established means of payment. The *cheque habit* would develop by the facilities granted by these banks for the collection and encashment of cheques, and money would tend to become attracted to them in the form of deposits. And the larger the amount of money that goes to the mofussil banks as deposits the *greater and cheaper* is the *credit facility* they would be able to give to business men on the spot. *Money* would tend to become *more evenly distributed* throughout the country and money rates would as a consequence tend to become steadier. The risk and the cost of transmission of money from the cities to out-stations would also be considerably reduced.

(C) *Savings in Currency* :—There has also to be considered the benefit that the currency system of a country

obtains. The enormous saving in the manufacturing, handling and use of currency can be illustrated from the clearing operations of the Federal Reserve System of America. In the year 1926, as many as 823 million cheques were collected at par by the Reserve System and their total value aggregated 273 billion dollars. But if the clearing of all 325 clearing houses is considered, the value of cheques cleared totalled the colossal figure of nearly 525 billions of dollars during this one year.¹ More important to note is the increase in clearing after the institution of the Central Clearing system by the Federal Reserve System. In the year 1916 the value of cheques collected was only 13 billions of dollars, whereas in 1926 the collection increased to 273 billions of dollars.

A comparison of the clearing house operations in India with that in the United States of America will be instructive in showing what is being done and what could be done by a country-wide system of cheque clearance in India.

IN CRORES OF RUPEES

| Country | Year | |
|------------------------------|--------|----------|
| | 1913 | 1926 |
| INDIA . . . | 650 | 1,591 |
| United States of America . . | 47,430 | 1,46,475 |

Clearing House operations in Indian and United States of America compared.

COLLECTION AT PAR:—But if economy in the use of metallic and paper currency is to be obtained, the cheque must step in to replace both. No encourage-

¹ Burgess: *The Reserve Banks and the Money Market*, Pages 68 and 79.

ment would be given to the cheque habit unless there is a guarantee that the cheque will be paid for *at par*. Unless the charges concurrent on the collection of cheques are removed, creditors cannot be induced to accept them in payment. The Reserve Bank should therefore follow the example of the Federal Reserve System of America in instituting and developing the cheque collection system on a *par* basis.

CHAPTER VII

CENTRAL BANK AS THE BANKER OF THE GOVERNMENT

PART I.

Wherever a Central Bank is instituted it acts as the banker of the Government. In this capacity, its functions take mainly the following forms :—

- (1) It acts as the depository of the cash balances of the Government (and as its fiscal agent).
- (2) It is in charge of the currency reserves of the country and of their management.
- (3) It performs remittance operations on behalf of the Government.
- (4) It manages the public debt of the country.

(1) *As a depository of Government balances and Reserves and as manager of Public Debt* :—The importance of the Central Bank taking over charge of the cash balances of the Government and managing them will be made clear by specifying the various evils which resulted from the system prevailing in various countries *before* the institution of such a Bank. This system is generally known as the Independent Treasury System, in which the Government kept its balances in its own treasuries and sub-treasuries and received and made payments to the public directly through them. Briefly stated, its defects were : In the first place, it led to the locking up of enormous sums of money in the Treasuries with resulting loss of interest on the one hand, and increase in the State expenses in looking after them on the other. Secondly,

it paid no regard to the fundamental duty of the State towards the money market of the country. It completely divorced state finance from the market and left it to find its own salvation. The primary task of the Government was to administer its finances in the most economical and efficient way possible. It did not therefore concern itself with what was happening or might happen in the money market. It gave little or no help in normal times to develop the country's business and trade, and in abnormal times the position was desperate.

Thirdly, the management by the Government of its own cash balances resulted at times in serious disturbance to the money market. At certain times of the year, large accumulations were made in the Government treasuries as taxes were paid into them. But this resulted in the sudden withdrawal of money from circulation into the hoards of the Government ; that is, it led to a contraction of currency and consequent disturbance to the money market. At other times of the year when disbursements were made by the Government, money was suddenly poured into the money market with the result that inflation of currency took place and disturbed the money market. And when it is noted that the receipts and the disbursements by a Government are on a substantial scale, their effect on the rates of interest in a country and therefore on its credit situation is quicker and more substantial than those brought about by changes in the deposits of the Banks.

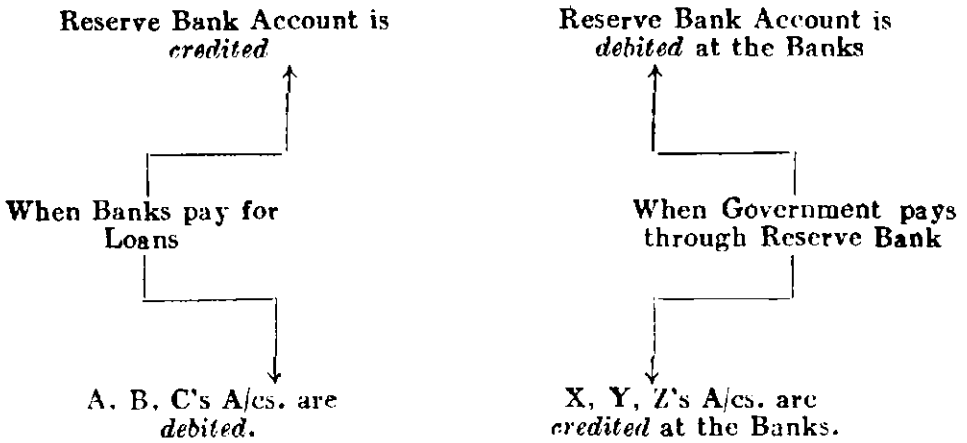
In order to remove some of these defects, the Government began to deposit with a banker or banks some part of its balances. Such deposits were maintained without any payment of interest by the Bank, which was given the privilege of loaning some proportion of the balances,

under restrictions, to the money market. But the defects were far from being mitigated. The amount which the Bank could loan was not adequate to meet the growing needs of the money market in normal times, and changed with the changing views of the different heads of the Treasury, and in times of financial crisis the bank looked upon the Treasury as its saviour. Moreover, the placing of the balances with a particular bank or a few banks brought upon the Government the charge of showing favouritism.

AN INTERMEDIARY FOUND INDISPENSABLE :—An intermediary was, therefore, found necessary between the Government and the money market who could know intimately the requirements of business or trade and could manage the Government balances not merely in the interest of the Government itself but to the benefit of the money market also. Such a middleman was found in the Central or the Reserve Bank.

The Government operations which substantially affect the money market are the collection of taxes, the sale of short-dated Treasury Bills to meet temporary requirements and the floating of loans, all of which are likely to cause undue contraction of currency. When the Government redeems its matured loans or makes large payments for various obligations incurred by it, undue inflation of currency is the likely result. But the Bank's intimate knowledge of the market enables it to handle huge Government receipts and disbursements smoothly and effectively. One important factor which enables huge Government transactions to be carried out without disturbing the money market is the very nature of banking business. Thus, supposing the Government is obliged to issue a big loan to meet extraordinary expenditure, the mecha-

nism for adjusting the amount of receipts and disbursements would *in general* take the following simple form.



As the above diagram explains, when, for example, A, B, C buy loan scripts, their bankers debit their accounts and credit the Reserve Bank with deposits to the same extent. But when the Government has to pay, say, X, Y and Z for commodities supplied by them, the accounts of the latter would be credited at their Banks and that of the Reserve Bank would be debited accordingly. Consequently, as the great controller of the banks of the country and their reserves the Reserve Bank can use the ordinary *mechanism of credit and debit* so effectively that adjustment in the transference of money from one party to another can take place quickly (and when found necessary) without disturbing the monetary circulation in a country.

Besides, the Bank knows how best to spread these transactions over a *period of time* and *distribute* them throughout the country. Being in charge of credit control, it can measure the requirements for currency accurately, can prevent extra funds from disorganizing the money market by using ways and means to absorb the surplus, and never allow the market feel the dearth of

money by spreading the collection of money on behalf of the Government over a period of time.

In giving an account of the achievement of the Federal Reserve Banks of the United States of America in this respect Professor Kemmerer states, "The total amount of money in circulation in this country in 1919 was only between \$ 5,000,000 and \$ 6,000,000 and the Federal Government was receiving over its own counters in one year five to six times the total amount of money in circulation in the country. It could not hold this money out of circulation. And as quickly as it received the money, it put it back into circulation through the instrumentality of the Reserve Banks without disorganizing the money market."¹ The service rendered to the Government by the Federal Reserve Banks could also be estimated from the fact that during the year 1919 nearly 33 million Government cheques amounting to \$ 14,500,000,000 passed through them and their branches.² But this colossal amount was so well distributed that normal interest rates prevailed in the market.

AS REGARDS INDIA :—As regards India, since the abolition of the Independent Treasury System, the cash balances of the Government have been placed with the Imperial Bank of India. The Bank acts as the only banker to the Government and transacts all its business. It has the custody of public funds and the balances of the Secretary of State through its branch in London. The following figures show the Government balances at the

¹ Kemmerer : The A B C of Federal Reserve System, Page 95.

² Mr. Burgess in 'The Reserve Banks and the money market' (Pages 99-100) gives a typical example of the burden borne by one of the Reserve Banks. The volume of operations of the New York Federal Bank on a single day—15th of March, 1927, was close to 2 billion dollars including both transactions for Treasury and ordinary banking operations. But that was carried on without causing disturbance to the Money Market.

Imperial Bank of India and at Government Treasuries in India.

Treasury Balances in India

(Average per last day of each month)

IN LAKHS OF RUPEES

| During | Balance at | |
|---------|-----------------------|------------------------|
| | Government Treasuries | Imperial Bank of India |
| 1925-26 | 2,67 | 16,88 |
| 1926-27 | 2,49 | 19,99 |
| 1927-28 | 2,30 | 10,56 |

The location of the Balances in India and England is shown below.

Treasury Balances

IN LAKHS OF RUPEES

| | In India | In England | TOTAL |
|-----------------|----------|------------|-------|
| 1st April—1927 | 27,88 | 4,35 | 32,23 |
| 31st March—1928 | 9,16 | 7,61 | 16,77 |

As the major part of the balances are kept with the Imperial Bank it may be thought that considerable help is given by the Bank to the Indian money market, by way of the easiness with which Government transactions are undertaken by it and by giving loans freely to meet the seasonal demands for money. But these advantages do not obtain for the following principal reasons. Briefly stated they are, (1) that the transactions of the Bank are limited by law. It is entirely prohibited from doing certain kinds of business and restrictions are placed upon its power to loan money. As stated previously, in order to relieve the seasonal stringency, it is empowered to issue emergency currency to the extent of Rs. 12 crores, but

that amount is not found sufficient to meet the situation. Secondly, in spite of the existence of the Bank, the Government of India and the Secretary of State themselves undertake independently a considerable amount of banking business which at times has caused serious disturbances to the money market. And thirdly, the Bank is not in charge of the currency reserves. *Government has the sole custody of these reserves* and their location is shown in the following statement.

The Reserves
IN LAKHS OF RUPEES

| | | 31st March 1928. | | |
|------------------|----------------|------------------|------------|---------|
| | | In India | In England | TOTAL |
| Currency Reserve | Paper { Silver | 1,06,38 | ... | 1,06,38 |
| | Gold | 29,76 | ... | 29,76 |
| | Securities | 37,96 | 3,77 | 41,73 |
| Standard Reserve | Gold { Gold | ... | 2,87 | 2,87 |
| | Securities | ... | 50,46 | 50,46 |

THE RESERVE BANK NEEDED:—It is only when the balances and the reserves are in the custody of the Central Bank and are managed by it that the evils which result at present (and to which reference was made previously) can be removed. The money market will then get substantial relief because larger amounts of money will be made available for it through the Bank, and the Bank's better adjustment of the supply of currency to meet the demand will bring the benefit of steadier rates of interest, and as the fiscal agent of the Government the Central Bank will manage Government transactions so efficiently that the money market, far from being

disorganized, will acquire that supreme confidence as important as it is desirable in the interests of businessmen. Besides, from the point of view of India as a whole, the Reserves will be used more economically and in the interest of the country's business and trade, and the Bank will be enabled to establish a credit policy on which the entire structure of credit will depend. It will also remove that long standing suspicion that India's Reserves are used to some extent to benefit the London money market and not the Indian money market.

REMITTANCE OPERATIONS:—It can also do another service to the State. By its great influence and by giving facilities to banks and other investors it can induce them to buy Government loans and thereby make the issue of them successful. Most Governments have also found the necessity of issuing short-dated Treasury-Bills to meet temporary expenditure pending the receipt of taxes.

The Reserve Bank can float these on the best terms possible, for being in intimate contact with the money market it will know better the condition of money rates from time to time. For instance, if the money market is easy and there are surplus funds with the banks awaiting investments, it will issue the bills successfully and at the same time afford an opportunity to the banks to invest their funds. On the contrary, if there is stringency and money rates are going up, it will withhold the issue lest both the Government and the money market suffer, the former by the higher rates necessitated, and the latter by greater stringency in the market.

EXTENT OF GOVERNMENT REMITTANCE OPERATIONS:—Other important business which the Reserve Bank will have to transact on behalf of the Go-

vernment of India concerns the remittance operations to meet its obligations in London. The Indian Government's remittance operations are a special feature in the economy of India. The Government of India has at present to remit *annually* some £ 35 millions to London to pay for what are known as the *Home charges*, viz., for loans contracted for railways and irrigation and payment for its purchase of bar silver, stores purchased, pensions and furlough allowances etc. This amount forms a *very much larger proportion of the total remittance business of India than probably that of any other country*. In expressing the importance of the Indian Government's remittances, Sir Basil Blackett, late Finance Member, said, "Even when, just after the War, the British Government was remitting four or five million dollars a year to America, that was a much smaller proportion of the total remittance business between London and America than the figures I have given for India."¹

THE METHODS OF REMITTANCE BY THE GOVERNMENT :—At present the Government *directly operates in the exchange market* and considering the large proportion of its transactions to the total, its operations form a dominating factor in the Indian exchange market. The present method of remittance is by the *purchase of sterling in India*, sometimes by public tenders and at other times by private purchase. The purchases are made through the Imperial Bank of India which in turn buys sterling bills through the Exchange Banks.

The mechanism for Government remittances used before 1923 was different. Then, the Exchange Banks used to buy sterling bills in India which were rediscounted

¹ Minutes of Evidence taken in India before the Royal Commission on Indian Currency and Finance, Vol. IV, Q. 599.

by their London Head Offices in the London Money Market and with the proceeds they bought what were called 'Council Bills' or 'Telegraphic Transfers' of the Secretary of State, who by the sale of these Bills received gold to meet the Home Charges. The Council Bills when presented to the Government of India were paid for in rupees in India. This method was not merely complicated and inconvenient to business men but also gave to the Secretary of State undue power in the exchange market.

ADVANTAGES OF THE PRESENT METHOD:—The present method of buying sterling in India has set the machinery working in the right direction. In the first place, since India is the place where the bills are enacted for the country's surplus of exports over imports and also the liability to make remittances, it follows as a natural consequence that it is in India that bills should be purchased by the remitter. For this reason the method is suitable to local conditions ; is simple, and is conducive to facilitating trade in India. The factors influencing the immediate course of exchange can be gauged more accurately and more promptly in India. Besides, since the remitter, i.e., the Government, knows well its day to day cash position, it is rightly given the initiative in the execution of its liabilities for financing the Secretary of State. Further, knowing well the Indian Money Market, the Government of India ought to be able to transact remittances in a more economical way.

The system of purchasing sterling in India by public tenders brings many advantages. It removes the suspicion created in the minds of the people by a private purchase system that certain parties are being favoured, and is, therefore, more equitable. The public tender system

also makes known the time and the amount of the remittances which the Government demands and thereby obviates the element of speculation which the uncertainty created by private purchase tends to establish. And to the Government the advantage consists in getting the best rates for remittance by initiating free competition among the sellers of sterling.

GOVERNMENT REMITTANCE AFFECTS THE EXCHANGE MARKET :—That the Government remittance operations must influence the exchange market in India is obvious. When a very large proportion of total remittances to London is made by the Government, it is the Government rate of purchase of sterling that establishes the rate of remittances by private individuals and firms. Indeed the supply of bills depends on India's balance of trade. In dealing with the effect of Government remittances the Royal Commissioners wrote, "The action of the Government by which in recent years part of the remittance first put through the Treasury was subsequently put through currency, shows that the *Government cannot carry on its remittance operations irrespective of their effect on the Indian Money Market or on currency policy.*"¹

REMITTANCE IS ESSENTIALLY CENTRAL BANKING BUSINESS :—Since the Reserve Bank will be under the obligation to maintain the value of the currency, it is essential that remittance business should also form a part of its functions for the two obligations are intimately related. Remittance business has not merely an important influence on the currency system but also on the rate of exchange and the money market of a country. It follows then as a natural consequence that all

¹ Report of Royal Commission on Indian Currency and Finance, Page 42.

these functions should be centred in the Reserve Bank, if it is to discharge all its obligations satisfactorily.

Even with the transfer of the Government remittance operations to the Reserve Bank, the domination of remittance for the Home Charges over the exchange market will continue unless there is a substantial lessening of these charges. A reduction in these remittances will take place on behalf of the Paper Currency Reserve and the Gold Standard Reserve, for as soon as these Reserves are handed over to the Reserve Bank such remittances must automatically cease. But generally the domination will not be so acutely felt as it is under the present system. It will be an *ordinary* and *commercial* method instead of an extraordinary and official method. Being in very close contact with the exchange market the Bank will possess more accurate knowledge of the circumstances prevailing therein, and will consequently make remittances so smoothly that there will be fewer fluctuations in rates with benefit both to trade and the country generally. With the balance of trade in favour of India the Reserve Bank may normally be expected to transact remittance business smoothly.

But the situation will become difficult when owing to a failure of the rains in India the exports fall off and the trade balance goes definitely against the country, and sufficient bills are not to be had. Under such circumstances, to make remittances for the Home Charges at the official ratio would become extremely difficult. The Bank's resources might be strained to breaking point and its credit affected, and this in its turn might jeopardise the whole financial fabric of India. The experience of 1926-27 may be taken as an illustration to show the difficulties of such a situation. During that year the Government

were not able to remit to England by purchases of sterling in the open market” in spite of good harvest in India, owing to world prices for India’s main exports being low.”¹

There is apprehension in many quarters that, in years of unfavourable trade balance, in the absence of any express provision, the Secretary of State may compel the Bank to part with the gold assets of the Note Issue Department to finance his current disbursements when the position of the Reserves is weak, and the Bank would have to maintain the value of the rupee at parity with gold. “Such apprehension exists” wrote the late Mr. B. F. Madon, “because in India the currency reserves have been frequently raided in the past to meet the liabilities of the Government outside its own borders..... Thus the Currency Reserves have been deprived of a very substantial amount of £ 26 million by the Government in only 10-12 months to finance the Secretary of State.”² But such an apprehension can be removed by making a clear provision in the Statute that the Reserves of the Issue Department are solely meant for maintaining the parity of India’s currency with gold.

However, two other provisions are necessary to enable the Bank to furnish the Secretary of State with funds during the period when the trade balance is adverse to India. During such a period (i) the London branch of the Reserve Bank should be asked to borrow money in London up to the amount necessary to make up the deficiency in the remittances and (ii) any loss incurred should be borne by the Government and not by the Bank. The first provision would leave trade breathing time to re-

¹ Memorandum on the Reserve Bank of India Bill, submitted by Merwanji & Co., Stock, Bullion and Finance Brokers, Bombay.

² Memorandum on the Reserve Bank of India Bill.

cover and the second would leave the credit of the Bank unimpaired during the emergency.

There will also be essential limitations placed upon the capacity of the Reserve Bank to transact business in exchange. It should be allowed to make remittances to London for its customers for *bona fide* requirements only (including the actual requirements of the Secretary of State). The same limitation should also apply to its London Office. In addition, it should not be allowed to deal direct with business men but should be permitted to do so through the banks and those firms which are approved by the Bank Board. Further, it should be laid down that the Reserve Bank should limit the remittance operations on behalf of the Government to the *actual amount of the Home Charges and no more*.

CONCLUSIONS :—To conclude, if the Reserve Bank has to transact business on behalf of the Government as its banker, it should observe certain fundamental principles in fulfilling its functions, namely,

(1) it should be perfectly upright in its dealings and no element of favouritism should be displayed in doing this business and

(2) it should transact business, whether Treasury or remittance business, so efficiently and smoothly that a minimum or no disturbance should be caused to the money market of the country.

CHAPTER VIII

BUSINESS WHICH A RESERVE BANK MAY NOT TRANSACT

DEFINITE RESTRICTIONS NECESSARY :—

In discussing the functions of a Reserve Bank stress has all the time been laid on the two most important principles which should be the watchwords of the Bank, namely, (1) absolute *safety* and (2) maximum of *liquidity* of its assets. Not only should it be the safest institution as regards the custody of the nation's reserves, but it should so hold the reserves that they may be made as quickly liquid as possible in times of stress. Every other consideration has to be subordinated to these two principles, because a Reserve Bank is a national institution in whose hands is placed the financial destiny of the entire nation.

Consideration was also given to the limitations under which certain of its functions, such as the making of advances and rediscount business, should be undertaken. But these do not go far enough, and in order that the two essential principles of safety and liquidity should be completely secured, the charter of a Reserve Bank must prescribe definite restrictions on its functions in the clearest and most emphatic terms. It should not be content with simply stating under what limitations certain functions shall be undertaken, but it should also state what business it shall *not* do under any circumstances.

As regards the nature of the business it is necessary that nothing should be left to the discretion of the authorities of the Bank. There should be no room for any interpretation to be laid by them on any of its Statutes.

TYPICAL LEGISLATION OF SOUTH AFRICAN RESERVE BANK :—In this connection the Act governing the South African Reserve Bank may well be quoted as a typical example of legislative restrictions on the Reserve Bank. It states that the Bank may *not* :—

(1) engage in trade or have any direct interest in any commercial, industrial, or other undertaking not specially provided by its permissible business ;

(2) purchase its own stock or shares of another bank, or grant loans on the security of same ;

(3) advance money on mortgage of fixed property or become owners thereof, except for its own business requirements ;

(4) make unsecured loans or advances ;

(5) draw or accept bills payable otherwise than on demand ;

(6) accept money on deposit for fixed term or allow interest on current accounts.

Clauses (4) and (5) have already been discussed in a previous chapter ; the rest will be considered in this chapter.

Clause (1) sets a proper limit on the true functions of a Central Bank. Commercial banking does not form part of its functions. It is debarred from having any direct interest in any commercial, industrial, or other undertaking and is consequently freed from the risks and dangers consequent on such transactions.

Besides, commercial business is foreign to the nature of a Reserve Bank. It is not instituted for the purpose of doing ordinary commercial business and thereby becoming a serious rival to the commercial banks of the country. It is therefore essential that the Bank shall not be permitted to do such business except in so far as it is

necessary for the purpose of liquidating a debt due to it, in which case the interests shall be disposed of at the earliest possible moment.

Clause (2) :—The first part of the clause emphasizes the point that the Bank shall not purchase its own stock. This is so because such a purchase would amount to a reduction of its own capital and consequently endanger the interest of the depositors who would find that this reduction led to diminished security being offered to them. Besides, indulgence in such business would harm the credit of the Bank, which might be suspected of dealing in its own stocks with a view to making profits. Lending upon the security of its own stocks is liable to the same objection.

Purchasing the shares of any other bank or company or granting loans on the security of the same is objectionable on the ground that the security is not safe. Not only are such shares liable to fluctuations in value, but in the case of the failure of such an institution the security becomes unrealizable. To avoid these risks, therefore, the Charters of various Central Banks enforce such restrictions.

Clause (3) is a very important consideration. If a Reserve Bank is permitted to lend money on the security of fixed property, it involves its assets in great dangers. The value of land is never steady, and in a country with uncertain seasons it is subject to wide fluctuations. So, if the Bank is compelled to realize its land holdings in time of depression, it would be involved in dangerous losses, particularly because land is worthless as a liquid security. What is true of land is also true of buildings, although in a lesser degree. It is therefore a sound policy to enforce this prohibition on the functions of a Reserve Bank.

Ownership of immovable property is only admissible in so far as it is necessary for the Bank's own business premises and residence for its officers and servants.

The holding of a mortgage on fixed property as security should only be permissible in case *additional* security is needed to cover any loss in value of another security held by the Bank against any loan or advance made to a customer, or if any debt is regarded as doubtful. Legislation to this effect exists in the charters of certain Central Banks such as the Bank of the Republic of Colombia.

But in direct contravention of this essential provision which should control a Reserve Bank stand the Charters of the Commonwealth Bank of Australia and the Bank of Finland. In Australia, the Commonwealth Bank is empowered, like the commercial banks of the country, to do ordinary commercial business and to loan money on the security of fixed property. But this latter function "has arisen from their policy of supporting the development of the primary industries to the utmost of their power and resources."¹ It has a special branch called the Commonwealth Savings Bank of Australia which does Savings Bank business on a very extensive scale. Its liabilities totalled £ 52,635,368, whereas those of the general department, the Commonwealth Bank of Australia, amounted to £ 97,921,005 at 30th June, 1929.² However imperative the circumstances may be in entitling the Commonwealth Bank to perform these functions, in this respect it is *not* functioning as a true Central Bank. The nature of its business is of a hybrid character and goes against the fundamental principle of Central Banking.

¹ A. C. Davidson: Central Reserve Banking, Page 17.

² Thirty-Fourth Balance Sheet of the Commonwealth Bank of Australia and Third Balance Sheet of the Commonwealth Savings Bank of Australia.

Clause (6) :—In previous chapters, it was shown how essential it was for a Central Bank to have the custody of the reserves of the commercial banks for the control of the credit policy, and as the fiscal agent of the Government to hold the balances of the Government. The question is : should the Bank be authorized to accept money on deposit from private persons? For various reasons, it is desirable that it should *not* do so.

In the first place, receiving deposits from the public is the function of an ordinary commercial bank and therefore goes against the basic principle of Central Banking business. The two should function separately. It is also unfair on the part of an institution hedged round by special privileges to enter into competition with commercial banks. Far from being a competitor, it has to be the protector of these banks in time of stress. Then the question of the safety and liquidity of the Bank has to be considered. The acceptance of deposits from the public increases the liability of the Bank and thereby increases the risk and endangers the liquidity of the institution, which is tempted to loan out the money so obtained. How could the Central Bank be a Bankers' Bank and give assistance to other banks in time of need when it is called upon to repay the money of depositors on the one hand and to advance money to its customers on the other, and that too at a time when many of its securities might not be in a liquid form? If the institution is to perform its functions with perfect independence and integrity, it should be prohibited from involving itself in the risk of lending the money of private individuals.

But a stronger objection has to be raised against the payment of interest on deposits by a Reserve Bank. Not only do the above arguments become effective with great-

er force, but the payment of interest burdens the Bank with an additional liability to meet which it would be compelled to look to profits as one of its chief aims. This might involve it in risks which are not within its proper sphere. "The refusal to allow payment of interest to customers may therefore be viewed in the same light as limitations on the amount of dividends to shareholders, which is a recognized feature in Central Reserve Banking."¹ A Reserve Bank is not created for the object of making profits. It is a national institution and as such should uphold the nation's interest rather than pay regard to the making of profits. It is imperative, therefore, that definite rules should be laid down forbidding the Bank from paying any interest on deposits.

The Federal Reserve Act of the United States of America definitely forbids the acceptance of deposits from the public and permits the receipt of current deposits from non-member banks or trust companies "solely for the purposes of exchange or of collection"² and only on condition that such an institution "maintains with the Federal Reserve Bank of its district a balance sufficient to effect the items in transit held for its account by the Federal Reserve Bank." In the case of Australia the position is entirely different. The Commonwealth Bank does accept time-deposits and does allow interest on current accounts; these transactions are on a considerable scale. Time-deposits totalled nearly 31 per cent. of the total liabilities of the Bank in its balance-sheet. The current accounts stood at £ 33,000,000 of which £ 6,000,000 were bearing interest.³ This indeed is not a desirable feature of the

¹ A. C. Davidson: Central Reserve Banking, Page 20.

² Federal Reserve Act: Section 13.

³ League of Nations: Memorandum on Currency and Central Banks, Vol. II, Page 89.

Commonwealth Bank. In Great Britain, the principle of not permitting the payment of interest is recognized, "in the established custom of the Bank of England, which has only departed from it in exceptional circumstances arising out of the war."¹

SHOULD IT TRANSACT BUSINESS FOR THE PUBLIC? If a Central Bank accepted current deposits from the public it would also have to do other private business. That business, for instance, includes the buying and selling of stocks and shares, the collection of interest and dividends, receipts and payments on the depositors' behalf and so on. These are the legitimate functions of a commercial bank and should on no account be entrusted to a Reserve Bank. If it is argued that by permitting the Reserve Bank to transact this kind of business additional facilities would be supplied to the public, these facilities had better be given by the establishment of additional commercial banks or by extending the branches of those already existing. The grounds for this have already been made clear, but an additional objection may here be stated. On no account should the managers of the Bank be distracted from concentrating their energies on the true functions of the Bank by such supplementary transactions which involve an additional strain on them. In this respect, the legislation of the United States of America is in marked contrast to that of Europe. Whereas the Federal Reserve Act does not contain any provision empowering the Federal Banks to do this sort of business on behalf of the public, in Europe the Central Banks in general are authorized to transact it.

CAN IT BORROW MONEY? If a Reserve Bank is managed with ability and wisdom and in the interest of

¹ Kisch and Elkin: Central Banks, Page 136.

the nation, the question naturally arises—why should it be required to borrow money? A Reserve Bank would have to borrow money *directly* for either of two objects. (1) It may need the money for the purposes of its own business or (2) for the sake of influencing the credit situation in the country.

If the Bank has the second object in view, legislation must *not* permit it to borrow directly, because (as explained in the part 'Open-market operations') it can exercise sufficient control over credit by the sale of bills and securities in the open market. It is, therefore, unnecessary to give it additional powers in this respect. Besides, frequent borrowing by the Bank for this purpose, however judiciously carried out, would have the effect of damaging its reputation and of creating a panicky feeling in the money market of the country. It would tend to create suspicion in the minds of business men regarding the real object of its borrowings.

But if money is borrowed for the purposes of its own business, permission to do so should only be granted to the Bank under definite restrictions. In the first place, it should specify the *maximum amount* that could be borrowed at any time and lay down a certain ratio between the assets of the Bank and the sum to be borrowed by it. The law should also prescribe a *time limit*, which should be as short as possible.

A third provision also seems necessary. The Bank should publicly announce the *purpose* for which such commitments have been made, thus allaying all suspicion and enabling it to receive the co-operation of the public in meeting the situation.

These provisions weigh more heavily when consideration is given to the Reserve Bank's borrowing, not in the

domestic market, but in a foreign country. It would be hazardous to permit the Bank ordinarily to borrow money from a foreign country, as such borrowing brings additional complications. A foreign loan has to be repaid in foreign currency and appreciation in the value of that currency might involve the Bank in great losses. Then there is its adverse effect on the *exchange* situation of the country. If the foreign loan is incurred to establish backing for additional note issue, it follows that such issue might lead to inflation of currency and therefore to a general rise of prices. Imports would thereby be encouraged and exports discouraged, and the trade balance would tend to become unfavourable to the country and dislocate the exchange. Not less appreciable is the influence of the Bank's borrowing on the morale of the money market. In the face of such results, it would be wise policy to legislate that borrowing by the Reserve Bank could only be undertaken if special sanction is obtained from the legislature of the country. Better still, such an operation should be left to be performed as between one Government and another instead of between one Reserve Bank and another.

Many Governments of Europe have transacted foreign loans for the stabilization of currency or by being pressed to incur fresh expenditure. Some have done so subject to specific provision in charters ; whereas others have had to get their charters amended to obtain permission.

THE LEGISLATION FOR THE RESERVE BANK OF INDIA :—In the matter of definite restrictions to be placed on the transactions of the Reserve Bank of India, the proposed legislation follows very closely and, very rightly so, the clauses laid down for the South African Reserve Bank. But in the case of India the

Bank is to be permitted to receive non-interest-bearing fixed deposits from private persons.

In the Statement of Objects and Reasons affixed to the Bill, the reason as simply stated is that "it is considered by the Government of India that like other Central Banks in the world the Reserve Bank of India should also be allowed to receive deposits from private persons provided no interest is paid." But for the reasons emphasized previously, it would be prudent to take away this power from the Reserve Bank. Even the Royal Commission had laid down definitely that the Bank should not be authorized to accept money on deposits from private persons for a fixed term.¹

As regards the Bank's power to borrow money, the Bill authorizes it to do so for a period not exceeding *one month* for the purposes of the *business* of the Bank (and the giving of security for money so borrowed) under the following limitations :—(a) that the total amount of such borrowings shall *not* at any time *exceed* the amount of the *Share-Capital* of the Bank and (b) that money shall be borrowed under this clause from any person in British India other than a *scheduled bank*.

The Bank's power to borrow, whether in the domestic or the foreign market, is wisely circumscribed by the time limit of one month. The period is so short that the problems (referred to above) which affect adversely the interest of the country are not likely to make themselves felt. It is empowered to borrow money in the domestic market 'so as to facilitate the control of credit,'² but its power to do so is limited to scheduled banks in order to prevent it "from using its power of borrowing in order to

¹ Statements of Objects and Reasons affixed to the Bill, Page 19.

² Report : Schedule II, Page 97.

compete with other banks for fixed deposits.” It was stated in the beginning of this chapter that if the object of borrowing by the Bank in the domestic market is the control of credit, it should not be permitted to do so, for it possesses other weapons, such as the sale of bills in the open market, to exercise that control. But in India, as the Reserve Bank may find it difficult to obtain sufficient bills for this purpose, this duplicate machinery may have to be resorted to. However, as the period is limited to one month, special restraint is placed on this operation.

As regards the Bank's power to borrow in a foreign country an exception has to be made in the case of India. The principal reason is that it is under obligation to keep the Secretary of State in funds in London to meet the Home Charges. Consequently, if owing to unfavourable circumstances, it is not able to remit money on prescribed terms to him from India, recourse will have to be had to borrowing in London temporarily to fulfil its obligation. It would be prudent if the Bill were to specify *this* as the *only* purpose as well as *London* as the *only* place where the Bank has the authority to borrow money.

RESTRICTION ON BRANCHES :—Legislation should also restrict a Reserve Bank from opening its branches except in cities which are the principal centres of commerce and trade. If the Bank has to give its services as a true Bankers' Bank, it is desirable to restrict it from opening many branches and thereby entering into competition with the commercial banks whom it should on the contrary protect and help. Although the Bank of England has of its own accord restricted itself to very few branches, which number only eleven, the commercial banks of the country have a great grievance that “it competes with them in the country by under-cutting in the

matter of rates in a manner which annoys them seriously, and with some reason.”¹ This complaint against the Bank of England, which founded its branches largely in answer to a demand for them from the public, shows the necessity for legislation to restrict the number of branches of the Reserve Bank. It is a fact that the Banque de France has a number of branches (which numbered over 600 in 1924) established all over the country “to extend to the general public the benefits of cheap discount facilities”² which, owing to the rarity of the cheque system in that country, in practice results in the Bank discounting bills of the very low value of five francs and upward. But in spite of its many branches and the large financial help it gives to the public “it is not regarded by the other banks as a competitor because it does not allow interest on deposits or make uncovered advances in the form of loan or overdraft.”³ The Reichsbank of Germany too has a multiplicity of branches, which numbered nearly one hundred principal local branches and over four thousand sub-branches and agencies in 1924. This has much to do with the State’s anxiety and initiative in developing the industries of the country. Even the statutes of the Banque de France, which make no distinction between business with the other Banks and business with the public, have been taken as a model in drawing up the constitutions of most European Central Banks.⁴

But the right policy is to follow the example of the United States of America in paying due regard to the position of the Reserve Bank as a Bankers’ Bank, and eliminating its serious competition with commercial banks

¹ Hartley Withers : *Meaning of Money*, Page 224.

² Keith le Cheminant : *Colonial and Foreign Banking Systems*, Page 111.

³ Keith le Cheminant : *Colonial and Foreign Banking Systems*, Page 123.

⁴ Kisch and Elkin : *Central Banks*, Page 108.

by restricting the number of branches. Such restriction would also tend to keep the Reserve Bank out of commitments to the public which the Bank in its own interest should avoid. The proposed legislation for the Reserve Bank of India very wisely restricts the establishment of branches of the Bank to the principal cities, Bombay having the Head Office, Calcutta, Madras, Rangoon and Delhi and a branch in London. It may be argued that for a vast country like India multiplicity of branches would be necessary, especially to enable the Bank to transact business on behalf of the Government. But this business it can successfully do through its Agents, the Imperial Bank of India, Ltd. and others, about which more will be said in succeeding chapters.

Types of Central Banking

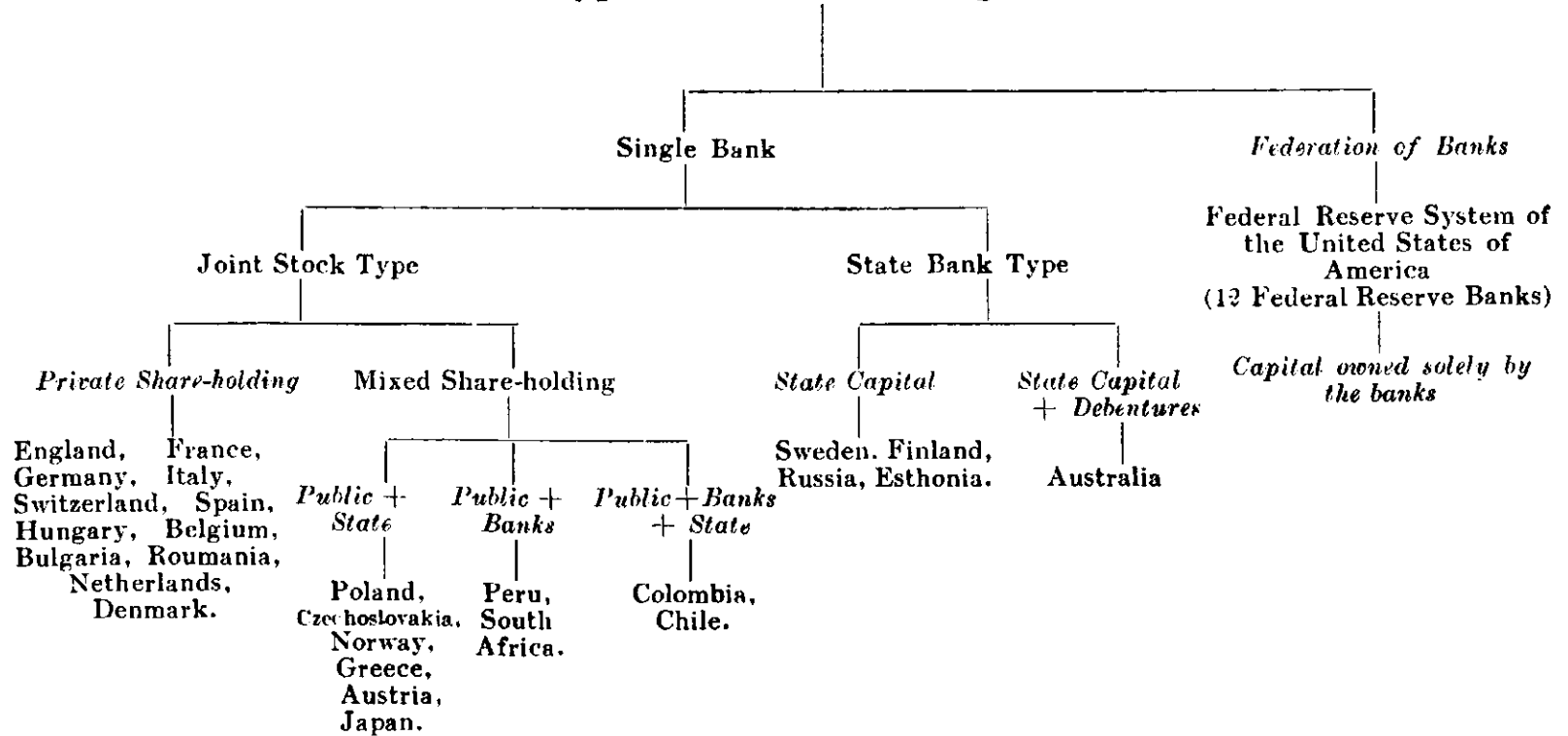


Chart illustrating the general structure of Central Banks.

CHAPTER IX

STRUCTURE AND MANAGEMENT OF CENTRAL BANKS

PART I.

The Types of Central Banking.

There are two principal types of Central Banking in the world. In the United States of America centralised Banking has taken the form of a *federation of banks* called the Federal Reserve System ; whereas in other countries of the world there is a *single unit* performing the functions of a Central Bank either with a few or many branches.

I. THE STRUCTURE OF THE FEDERAL RESERVE SYSTEM:—The Federal Reserve System consists of 12 Federal Reserve Banks in twelve important cities of the country. Geographically the country is divided into 12 reserve districts each of which has one Reserve Bank. Each district is apportioned “with due regard to the convenience and customary course of business and shall not necessarily be co-terminus with any State or States.”¹ And no district is made so large as to dominate the others and destroy the federal principle intended by the Law. In addition there are 24 branches and 2 agencies. To co-ordinate the activities of the Reserve Banks there is a *Central Governmental Body*, called the *Federal Reserve Board*, with its seat at Washington, under whose control the Reserve Banks work.

¹ Federal Reserve Act, Section 2.

The Capital of each Reserve Bank is *solely owned by the member banks* of the district in which it is located. The term 'member banks' is held "to mean any national bank, state bank or bank or trust company which has become a member of one of the Reserve Banks created by the Act." The stock is not transferable. The dividends on the stock shall be cumulative and are 6 per cent. per annum on the capital paid in. The net earning beyond expenses and dividends are in the beginning to be paid into a surplus fund, until it shall amount to 100 per cent. of the substantial capital stock of such bank and thereafter 10 per cent. of such net earnings shall be paid into the surplus. All remaining net earnings shall be paid to the Government of the United States as a franchise tax.¹ Thus the profit-making motive is removed from the policy of the Reserve Banks.

Besides, it is a peculiarity of the System that all member banks are required by law to keep their legal reserves on deposit with the Reserve Banks.

The National Banks are made *compulsory* members and those not joining the system forfeit their charters, but it is left optional to the State banks and trust companies to join the system. Each national bank of a district has to subscribe compulsorily towards the capital of the Federal Reserve Bank a sum equal to six per cent. of the paid-up capital stock and surplus of such bank, half of which is to be paid up at once. The others mentioned above can be members on the same terms.

No Federal Reserve Bank can commence business with a capital less than \$ 4,000,000 and in the event of the minimum not being obtained the Act provides that it should be opened to public subscription, and if the public

¹ Federal Reserve Act, Section 7.

fail to subscribe, the United States Government may subscribe for stock.

By June 1926, the member banks of the System totalled 9,400 or nearly $1/3$ of the total number of banks in the country, but in point of financial resources they represented "more than two-thirds of the banking strength of the country."¹

THE CHOICE OF A FEDERATION:—The choice of a system of 12 Reserve Banks with few branches instead of a single institution was due mainly to the geographical peculiarities of the country. In a country of prodigious distances such as America it was felt that a single institution if located, say, in a city in the East could not meet the needs of the West. The branches of a single institution would have to cover such immense distances that they would lose in efficiency. And as the vast country was studded over with thousands of independent banks with their varying banking activities, the most suitable plan evolved was a federation of these banks in suitable districts in order to keep up their individuality and at the same time to unite them into a unified system. Thus, "the adoption of the system of regional Reserve Banks, instead of one Central Bank, preserved the American principle of local autonomy."²

II. STRUCTURE OF THE CENTRAL BANKS IN OTHER COUNTRIES:—Central Banks in other countries take two general forms: (A) the Joint Stock type and (B) the State Bank type.

(A) *The Joint Stock principle*:—Those based on the

¹ Burgess: *The Reserve Banks and the Money Market*, Page 12.

² Burgess: *The Reserve Banks and the Money Market*, Page 2.

An additional cause is stated by Keith le Cheminant in his *Colonial and Foreign Banking Systems*, Page 149. He states, "In addition it was felt advisable to limit the power of New York as much as possible, as it was the centralization of reserves in that centre which had precipitated the Crisis of 1907."

Joint Stock principle can be sub-divided into (a) pure private shareholding (b) mixed shareholding. Most Central Banks in Europe have pure private shareholding and particularly those reconstructed after the War. Although the capital is subscribed wholly by the public, the Governments have in a majority of cases kept their control over the Central Banks in various ways, which are explained in the succeeding part of this Chapter. Besides, to ensure that the Bank has to function in the public interest and not for profit-making, the dividends are limited by legislation, the limit varying with different Central Banks.

In those Central Banks constituted on the mixed shareholding plan, there are three varieties. (i) In Norway, Czechoslovakia, Greece and Poland, the shareholding is divided between *the public and the state*. Although the Norges Bank of Norway is a private Joint Stock company, a large part of the capital was subscribed by the State. The National Bank of Czechoslovakia, which was created in 1926, is a Joint Stock bank in which the state holds one-third of the capital. In the shareholding of the Bank of Poland a certain portion of the capital was to be subscribed by the Government, according to a decree of January 11th, 1924 but 'when the subscriptions were closed (in April 1924), the capital proved to have been almost fully subscribed by the public; the Government, however, retained 10 per cent. for the account of the State.'¹ In 1927, when the capital of the Bank was increased in order to stabilize the currency, the additional shares were subscribed by the Government to be eventually sold to the public.

The Bank of Japan has private shareholding but there is a statutory provision that the Government may hold

¹ League of Nations: Memorandum on Central Banks, Page 293.

50 per cent. of the capital, although there is none held by it so far. ¹

Although the newly established Austrian National Bank is an 'independent Joint Stock Company' the Government controls more than a quarter of the share capital. ² Out of the total share capital of 30 million gold kronen, the Austrian Government subscribed 8 millions.

The Bank of Brazil started in 1923 has half its capital subscribed by the public and the remaining half held by the Government.

(ii) The second variety is illustrated in the Reserve Banks of Peru and South Africa. Both these banks are modelled on the Federal Reserve System of America but there are differences. In both Peru and South Africa the capital is subscribed by *banks and the public*. In the Reserve Bank of Peru, there are two classes of shares (A and B). The A shares are owned by the member banks and the B shares are subscribed and held by the public. *Only the A shares confer the right to vote*. But unlike the Federal Reserve System, there is *no obligation* imposed upon the commercial banks to become member banks, but any bank desiring to benefit by the Reserve Bank may join by subscribing 10 per cent. of its own capital towards A shares. In the Reserve Bank of South Africa one-half of the share capital is held by the commercial banks doing business in the Union, which banks under Section 10 of the Act had to subscribe 50 per cent. of the original capital in proportion to their own paid-up capital and re-

¹ The following may be noted as the big shareholders of the Bank:—

| | |
|----------------------------------|---------|
| Department of Imperial Household | 140,852 |
| Nabesheima | 3,600 |
| Mitsui Partnership | 3,276 |
| Sumitomo Partnership | 2,682 |
| Kanda Partnership | 2,617 |

² League of Nations: Memorandum on Central Banks, 1913 and 1918--1923, Page 85.

serve funds. Moreover, there is a provision in the Act that *every bank* doing business in the Union *must hold* shares of the Reserve Bank to the nominal value of not less than 5 per cent. of its own paid-up capital. The remaining half of the share capital was subscribed and is held by the public. The member banks are compelled by the Act, as in the United States of America, to maintain with the Reserve Bank certain balances against their deposit liabilities to the public.

(iii) The Bank of the Republic of Colombia and the Central Bank of Chile are examples of a great compromise between *the State, the banks and the public*. In each of these banks there are four classes of shares. *Class—A* shares are subscribed by the Government; *Class—B* shares are subscribed by the national banks of the country to a total of 10 per cent. of each national bank's paid-up capital and surplus in the case of Chile and of 15 per cent. in the case of Colombia; *Class—C* shares are subscribed by foreign banks doing business in each country in the same proportion as national banks, and *Class—D* shares are subscribed by the public.

In both Chile and Colombia the member banks are obliged by law to keep certain statutory reserves against their deposit liabilities.

(B) *The State Bank Principle* :—Wherever a Central Bank is owned by the State there is no shareholding and the initial capital needed for working the Bank is allotted from the exchequer. State Banks exist in *Sweden, Finland, Russia, Latvia, and Australia*. These Banks are naturally under the complete control of the Government. In the case of the Commonwealth Bank of Australia, the Act amended in 1924 provides for a capital of £ 20 millions, half of which was to be provided

by the Government from various funds stated therein and the remaining half, that is £ 10 millions, was to be obtained by the issue of debentures. The Amended Act states : "The Bank may from time to time issue debentures to such amount as it thinks necessary, but so that the total amount thereof current at any one time shall not exceed ten million pounds."¹ The debentures shall be for £ 10 or some multiple thereof and shall bear interest at a rate to be fixed by the Bank before the issue thereof.² The Commonwealth by this Act guarantees the payment by the Bank of the principal and the interest due in respect of any debenture issued by the Bank and for that purpose the 'Consolidated Reserve Fund' has been appropriated.³

The Bank of Esthonia established in February, 1919, has the legal status of a private Joint Stock Company under State control. "*In practice the bank is a pure State institution, all the shares being in the hands of the Government.*" According to an amendment to the original regulations, "the Government of the Republic acts in the capacity of the General Assembly of the shareholders, as long as the shares have not changed hands."⁴

FUNDAMENTAL CAUSE OF THE DIFFERENCES BETWEEN THE TWO MODELS :—The general forms of the Central Banks briefly described above explain some essential causes of the differences between the European and American systems. In Europe the Central Bank was in most cases born *before* the majority of the banks in the country. "It has been

¹ The Commonwealth Bank Act, 1911-1927, Part VI, 53.

² The Commonwealth Bank Act, 1911-1927, Part VI, 55.

³ Regulations under the Commonwealth Bank Act, 1911-1927, published in 1928 reinforce the power given to the Bank to issue debentures from time to time.

⁴ League of Nations : Memorandum on Central Banks, 1913 and 1918-1923 ; Page 164.

established," writes Professor Charles Dunbar, "because of the weakness of the defect of previously existing banking systems and because of the fact that it was desired to provide a means for the attainment of some very definite object; usually the development of a Government plan of fiscal reform."¹ The banking structure in those countries has grown up around its nucleus, the Central Bank. But the case of the United States of America is different. The country had a very highly developed and widely diffused system of general banking from which the country had benefited and it was upon such a structure that the Federal Reserve System was superimposed, because centralizing machinery was found necessary to bring the centralized banking structure into a unified system. It is because the Federal Reserve System was "grafted upon an already existing banking stem instead of being developed from the root as with European banking systems,"² that it has the structure of a true Bankers' Bank by the Act. That is why the Federal Reserve Banks are owned completely by those banks which formed the solid foundation on which the superstructure was raised.

PART II.

The Management of Central Banks.

The success of the credit policy of a Central Bank depends, as emphasized in a previous chapter, on the constitution of the Managing Board and its personnel. An attempt will, therefore, be made to review *very briefly* the structure of the Managing Boards of some of the Central Banks as a valuable guide to the formation of a Board to manage the Reserve Bank of India. In describ-

¹ The Theory and History of Banking, Page 263.

² The Theory and History of Banking, Page 267.

ing the Boards the plan of grouping the Banks designed above will be followed.

1. *THE FEDERAL RESERVE SYSTEM* :—The Federal Reserve System of the United States consists, as stated previously, of 12 regional Federal Reserve Banks linked together *under the control of the Central Board, the Federal Reserve Board.*

(a) *The Federal Reserve Board* :—The Federal Reserve Board consists of *eight members*, two of whom are the Secretary of the Treasury and the Comptroller of Currency, who shall be members *ex-officio*, and the *other six members are appointed by the President of the United States* 'by and with the advice and consent of the Senate.' In selecting the six members (1) not more than *one* shall be selected from any one Federal Reserve District and (2) the President 'shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and geographical divisions of the country.'¹

ITS POWERS :—The powers of the Federal Reserve Board are great and varied. It is empowered² (a) to examine the accounts, books and affairs of each Federal Reserve Bank and publish weekly reports on the same ; (b) to suspend reserve requirements under conditions laid down in the Act ; (c) to control the note issue of any Federal Reserve Bank ; (d) to suspend or remove any officer or director of any Federal Reserve Bank, and suspend the operation of any Federal Reserve Bank for any violation of Act and even to liquidate and reorganize it, if necessary ; (e) to exercise general supervision over the

¹ Mr. Burgess states in his *Reserve Banks and Money Market* : "Of the six appointed members of the Board in 1926, two were formerly lawyers, and the others were farmer, merchant, newspaper publisher and Economist." Page 172.

² Federal Reserve Act, Section 11.

Federal Reserve Banks ; (f) to compel one Federal Reserve Bank to rediscount for another at rates of interest to be fixed by the Board.

Besides, almost in every part of the Act the functions and importance of the Board are emphasized. Thus, the Board has the right to determine the character of the paper which the Federal Reserve Banks shall rediscount and to lay down regulations under which member banks may accept foreign and domestic bills. The loaning by Federal Reserve Banks, on short-time collateral notes is also subject to the review and determination of the Board. *The Discount rates of the Federal Reserve Banks, although fixed by the Banks themselves, are "subject to review and determination of the Federal Reserve Board."*¹

The Board has also certain functions in serving as a Central Clearing House for the collection of cheques and wire transfers. In addition, it has a number of other functions in which the Act abounds, but its indirect power, too, is very great. Its advice is invariably taken by the Federal Reserve Banks. Its powers have, therefore, a very effective voice in shaping the credit policy of the country.

(b) *The Federal Reserve Banks* :—The Federal Reserve Banks are themselves *semi-governmental* institutions. Each of these is administered by a directorate of nine members, three being appointed by the Federal Reserve Board and the *Chairman of the Board of Directors is one of them* ; none of the three may be an active banker, except the Chairman who is known as 'Federal Reserve Agent'. The remaining six members are elected by the member banks in the district, but three of these must be

¹ Federal Reserve Act, Section 13.

actively engaged in commerce, agriculture or industry. Business men are therefore in the majority on the Board. As regards its business with member banks within its district each Federal Reserve Bank is an independent unit.

(c) *Federal Advisory Council* :—To assist the Federal Reserve Board in forming decisions as to its policy there is a Federal Advisory Council, consisting of twelve members, one of which is selected from the Board of Directors of each Federal Reserve Bank.

II. *CENTRAL BANKS WITH PURELY PRIVATE SHARE-HOLDING* :—In the case of Central Banks instituted on the Joint Stock basis the general arrangement made in forming the Managing Board is a combination of members elected by the shareholders and those nominated by the Government. In most cases the Government, either by its power of nominating the Board or by other regulations, has kept its indirect control over the management of the Bank. And in most cases the representation of the various interests of the country, agriculture, commerce and industry, is also provided for.

THE BANK OF ENGLAND :—The case of the Bank of England is unique in the world. It is governed by a Governor, a Deputy Governor and 24 directors, all of whom are elected at the General Court of the shareholders. Of this number, at least 13, including the Governor and Vice-Governor, form the Court of Directors for the management of the Bank. It is an established custom that no banker can be a member of it. The Directors are elected annually and by usage some members of the Court of Directors are changed every year, but "the changes take place among the younger members, so that after some years of possibly intermittent service

the director's tenure of his position is practically for life. After many years he usually becomes Deputy Governor for two years in rotation, and then Governor for a like term, after which and for the remainder of his official life he is a member of an executive council of directors known as the Committee of Treasury. The director enters upon office, therefore, at an early age and reaches the positions of most active responsibility only after a long training in the Bank itself."¹ There is, thus, a system of government by rotation. In this connection Mr. Hartley Withers states: "*The Bank Court is a Committee recruited chiefly from the ranks of the accepting houses and merchant firms, and its members are nominated by itself, subject to the purely formal confirmation of the shareholders.*"²

THE BANK OF FRANCE:—In the Bank of France, the board of management, called the General Council, consists of twenty-one members of whom only three are Government nominees, that is, the Governor and two Deputy Governors, and the rest are elected by the General Assembly of the shareholders. It, therefore, seems as if the Government has very little influence over the management. But the General Assembly of the shareholders consists of *200 largest shareholders only* and the Directors (that is, members of the General Council of the Bank) '*are almost invariably men who have held high political office.*'³ And the chief executive head, the Governor, is appointed along with the two Deputy Governors by the Government for life.

THE SWISS NATIONAL BANK:—The Swiss National Bank is an example of a purely private corpora-

¹ Dunbar: *The Theory and History of Banking*, Page 166.

² *The Meaning of Money*, Page 216.

³ Keith Le Cheminant: *Colonial and Foreign Banking Systems*, Page

tion *completely controlled by the Government* of the country. The management of the Bank consists principally of (1) a supervising body, the Council of the Bank and (2) the executive committee of the Bank. Forty members constitute the Council, of which 15 are elected by the shareholders at the general meeting and the remaining 25, including the President and Vice-President of the Council, are nominated by the Federal Council of the Republic. Of the nominees, the Federal Council may nominate 5 members of Cantonal Governments and 5 members of Federal Chambers. The members of the Executive Committee are also appointed by the Federal Council on the recommendation of the Council of the Bank. They are three, of whom the President and the Vice-President are appointed by the Federal Council. To complete the control the Federal Council appoints even the directors of branches.

THE BANK OF SPAIN :—The management of the Bank of Spain consists of a Governor and two Deputy Governors, all of whom are nominees of the King, and a Council of 20 members. The shareholders elect fifteen and of the rest, the banks elect three, one represents agriculture and one represents commerce and industry. The shareholders are, therefore, in a clear majority but the *appointment of all elected members requires the sanction of the King*. It is possible then to anticipate the election only of those who would support the King's Government. Besides, the Governor is given the right to suspend any decision of the Council.

THE BANKS OF BELGIUM,¹ BULGARIA, NETHERLANDS AND DENMARK :—The constitutions of the Central Banks of Belgium, Bulgaria, the

¹ Information very kindly supplied by the Consul-General for Belgium.

Netherlands and Denmark have one factor common to all. In each of these banks there is a *Commissioner appointed by the King or Finance Minister to supervise the transactions of the Bank and to see that the Bank acts in accordance with the laws, statutes or interests of the State*. He has the right to attend meetings of all Committees and can protest against any decision of any Committee or Council of the Bank. In the constitution of Central Banks of Belgium and Denmark his protest amounts to a suspensive veto until the dispute is settled by the Supreme Court.

As regards the actual management of the Bank, the detailed constitution varies in these countries. In Belgium the management is in the hands of a Board of Directors composed of a Governor appointed by the King and three Directors elected by the shareholders, and a Council of Administration, which, except the Governor, is wholly elected by the shareholders. The Board is in charge of actual daily management, whereas the Council decides the general policy. But the Act gives great powers to the Governor who is given *the right to suspend the execution of any decision arrived at by the Council*.

In Denmark the management of the Bank is in charge of four or five managers, two of whom are appointed by the King. In the Netherlands Bank the Board of Directors consists of the President and Secretary, who are appointed by the Government from a nomination list prepared by the Management and the Commissaries (supervisors) and not less than two directors who are elected by the shareholders from a nomination list of three persons prepared by the Management and the Commissaries in a combined meeting. The Commissaries are also elected by the voting shareholders. For the past

few years there were five people on the Directorate.¹ The President and the Secretary may be dismissed by the King at the proposal of the combined meeting of the Management and the Commissaries. But in the National Bank of Bulgaria the management is in the hands of the Governor and Assistant Governors, all of whom are appointed by the King, although there is a Council with a majority of elected members of the shareholders to determine the credit policy of the Bank.

THE BANK OF ITALY :—In the Bank of Italy there is no Government nominee on the various councils of administration and management. Even the chief executive head, the Deputy General, and the Deputy Director General are elected by a Council consisting of shareholders' representatives, with the only limitation that the Government's approval must be taken. *But the note issue by the Bank is under the permanent control of the Finance Minister.* He presides over a Committee consisting of senators, deputies and Royal nominees, which controls the note issue. Besides, the *Finance Minister is given powers to exercise his veto over any decision of the various councils of the Bank which in his judgment is contrary to the laws and statutes.*

THE BANK OF GERMANY AND HUNGARY :—The Bank Law of August 30, 1924 which has reconstituted the Reichsbank is intimately connected with the system of the Dawes Plan and is going to be changed again, as soon as the Young Plan is to be put into operation.² Its present constitution cannot therefore be called normal.

The Managing Board, consisting of the President as

¹ Information very kindly supplied by the Consul for the Netherlands, Bombay.

² Information very kindly supplied by the Consul for Germany.

Chairman and 'the required number of members' must be German nationals. But the President is elected by a General Council which consists of 14 members, 7 of whom must be German nationals, while the remaining 7 members represent each British, French, Italian, Belgian, United States, Dutch and Swiss nationals. The members of the Managing Board, having been approved by the General Council, are appointed by the President. If the Reichs President refuses to sign the appointment of an elected President of the Reichsbank, another election takes place and on his refusing to sign the second appointment, a third election takes place which does not require his sanction. The shareholders have merely a consultative voice and on this account they have a permanent Committee. The Managing Board may obtain its opinion, if they think fit. With the participation of foreigners in the control of the Reichsbank it is no wonder that the Bank Law begins with the statement "The Reichsbank is a bank independent of Government control and having the character of a corporate body whose task it is to regulate the circulation of money in the whole area of the Reichs, to facilitate the clearance of payments and to provide for the utilisation of available capital."¹

But if the pre-War constitution of the Reichsbank were to be considered the position would be quite different. The State was then completely in control of the Reichsbank (according to the Bank Laws of 1875) through the Imperial Chancellor who had the direction of the Bank and had the Board of Directors under himself, while the shareholders were merely permitted to elect an advisory committee.

Under the reconstruction scheme the National Bank

¹ Bank Law of August 30, 1924.

of Hungary is 'entirely independent of the Government'. All members of the Board of Management except the Governor are elected by the shareholders. But the Government appoints a Commissioner and his Deputy to see that the Bank works in accordance with the Statutes and can protest against any decision of any Committee if it violates them and his protest amounts to a *suspensive veto* until the dispute is decided by arbitration.¹

CENTRAL BANKS WITH MIXED SHARE-HOLDING. (THE BANK OF POLAND):—The Bank of Poland is under the administration of a Council of 12 members elected by the shareholders, and, in addition, the President and the Vice-President of the Bank who are appointed by the President of the Republic. But the Minister of Finance has the right of vetoing (within three days) the election of any member on the Council.

The chief Director and other members of the directorate are nominated by the Council of the Bank, and their number determined by it, but *their appointment is also to be approved by the Minister of Finance*. Besides, the Bank President has the right of veto against any decision of the Council or directors, but his veto has to be approved by the Minister of Finance within three days. The Minister of Finance may also appoint a permanent Bank Commissioner for watching the interests of the State.

THE BANK OF JAPAN²:—In Japan the Law provides that all transactions of the Bank of Japan shall be controlled by the Government which shall amend any

¹Moreover, the Memorandum on Central Banks by the League of Nations, 1924, states: "under the reconstruction scheme above mentioned a financial adviser will be temporarily associated with the bank who will have a right of suspensory veto." It is not known whether such an adviser has been appointed, and if so, whether he is a foreigner or not.

² Information very kindly supplied by the Consul for Japan, Bombay.

measure passed by the Bank. Therefore, the managing Board of the Bank is so constituted that the Government effectively controls it. The Board consists of the President, Vice-President and four other Directors. The President and the Vice-President are appointed by the Government and so also the four other directors, but probably to pacify the shareholders, the method of appointment is that the shareholders in the general meeting elect from among them twice as many persons as are required to be directors. Half the number of persons so elected are then appointed to be directors by the Finance Minister to sit on the Board for a period of four years.¹ So that, the shareholders first elect eight members and the Government then appoints four out of them.

Besides, a person wishing to become a shareholder must first get permission of the Finance Minister to hold shares in the Bank.² The shareholders have got no direct control over the Bank except the right to ask questions in the general meeting, in accordance with the Act, constitution and standing rules. The Government has got supreme control over the working of the Bank and any act or conduct of business calculated to go against the Act or constitution or detrimental to the advantage of the Bank may be stopped from execution by the President who is given the right of suspensive veto. Further, under Art. 21 of the Act, the Finance Minister is authorized to appoint a Comptroller of the Bank who is empowered to examine all documents etc. and ask for condition of business of the Bank at any time and demand explanation on any matter relating to the business of the Bank and can also express his opinion in all meetings.

¹ Art. 45 of the Bank of Japan Act.

² Art. 6 of the Bank of Japan Act.

THE BANK OF NORWAY :—The management of the Bank of Norway is in the hands of a Board of Directors consisting of five members, three of whom are elected by the Legislative Assembly of the Country, the Storthing and the other two, the President and the Vice-President, are appointed by the King. The only active part the shareholders are permitted to play is in a council for Supervision, on which they are in a majority.

*THE BANK OF BRAZIL*¹ :—The Bank of Brazil is divided into four departments (Issue, Exchange, Commercial and Branches Departments) and each is administered by a director. The Bank as a whole is managed by a Board of 8 members. Of these, the President and the Directors of Issue and Exchange Departments are appointed by the President of the Republic, and the remaining 5 are elected by the shareholders. But the new statutes provide that the President of the Bank has the *right to veto* any decision of the Board of Directors or any other authority of the Bank.

THE BANK OF GREECE :—The Bank of Greece appears at least on paper to be the only bank of the class of banks with a mixed shareholding which has a minimum of State control. The Board of Directors consists of 11 members, including the Governor and Deputy Governor, all of whom are elected by the shareholders, but the election of the Governor must have the sanction of the Government. The utmost the Government can do is to appoint a Commissioner who has the right to protest against the decisions of any Committee of the Bank, and if his protest is upheld by the Finance Minister, it amounts to a suspensive veto and the dispute is taken to a special

¹ Memorandum on Central Banks by the League of Nations, Geneva 1924, Pages 102-103.

Commission of three members whose judgment is final. Any other dispute between the Bank and the Government is adjudged by a Court of Arbitration.

THE BANK OF AUSTRIA :—The management of the Austrian National Bank is like that of the National Bank of Hungary kept independent of the Government, under the plan of reconstruction laid down by the nations at Geneva. The members of the Board of Management are entirely elected by the shareholders with the exception of the Chairman, who is appointed by the President of the Confederation. But the exceptional quality of the constitution will be made evident from the fact that by the Statutes of 1923, “the President of the Confederation has appointed a foreign adviser to the Chairman and the Board of Directors, whose office shall terminate co-incidentally with that of the Commissioner-General of the League of Nations.”¹ And during this time all important decisions of the managers, the Board of Directors or the Chairman must be submitted to the adviser for approval.”² How far the Austrian Government will stick to this constitution will be clear only when it has cleared its debts completely and has taken itself out of foreign control. At present it has to submit to the statutes by which “the bank is expressly forbidden to grant, directly or indirectly, any advances to the State, the provinces or the communes unless they cover in gold or foreign currencies the amounts issued to them in bank notes.”³ The only control the Austrian Government has over the Bank is through the appointment by it of a Commissioner and his Deputy with the same powers as in the case of the National Bank of Hungary.

¹ League of Nations : Memorandum on Central Banks, 1924, Page 85.

² Do. Do. Page 85.

³ Do. Do. Page 85.

THE RESERVE BANKS OF PERU AND SOUTH AFRICA:—The Board of Directors managing the Reserve Bank of Peru consists of 9 members. Three of these are nominated by the Government, from whom the President and the Vice-President must be selected, although Government holds no shares. The remaining six are elected by the three classes of member banks, two being elected from each. The shareholders other than banks, that is, the public, have no representative on the Board.

The Reserve Bank of South Africa is managed by a Board of Directors consisting of 10 members.¹ Five of these, inclusive of the Governor and the Deputy Governor, are appointed by the Governor-General and the remaining five directors, called “the commercial and industrial representatives, who must be or have been actively engaged in commerce or finance, one in agriculture and one in some other industrial pursuit” are elected by the shareholders without distinction between banks and others.

THE BANKS OF THE REPUBLICS OF COLOMBIA AND CHILE:—A Board of Directors manages the Bank of the Republic of Colombia. It consists of 10 members, of whom 3 members are Government nominees, 4 members are elected by the national banks of the country, 2 members are elected by foreign banks and 1 member is elected by the public. Thus the representatives of the banks are in a clear majority. Even the Governor of the Bank is elected by the Board.

The Central Bank of Chile has a much wider representation than the Bank of the Republic of Colombia. It is

¹ By the Currency and Banking Amendment Act of June, 1923. In the original Constitution there were eleven members in all and the Stock-holding banks had separate representation on the Board.

managed by a Board of Directors consisting of 10 members, of which the Government has three nominees, national banks have two, foreign banks have one and the public one, but there is also one member representing the combined interests of agriculturists and manufacturers, one member represents commerce and one member represents labour. But the Government keeps indirect control over the Bank through a Superintendent of Banks, who is appointed by the President of the Republic. He has wide powers which he exercises over all banks within the Republic.

III. *BANKS WITH THE CAPITAL OWNED BY THE STATE.* *The State Bank of Russia*:—The State Bank of Russia, “named the State Bank of the Union of the Socialist Soviet Republics” is administered by a Board of Directors, the president being an official in the Commissariat of Finance. The Board further includes representatives of the co-operative movement and other branches of the State-controlled economic community. The issue operations are handled by a separate Issue Department under the control of the Board of Issue composed of two representatives of the Bank (the Bank president and the director of the Issue Department) and three other members delegated by the Stock Exchange, the State control Department and the Commissariat for Finance.¹ The Bank is responsible to the People’s Commissariat of Finances.

THE BANK OF FINLAND:—The Board of Management of the Bank of Finland consists of the Chairman and four other members all of whom are appointed by the President of the Republic. The Diet appoints supervisors under whom the Board of Managers transacts

¹ League of Nations: Memorandum on Central Banks (1924), Page 318.

its duties. These Bank supervisors have wide powers, including those of fixing the rates of discount and interest and the granting of credit.

THE BANK OF SWEDEN :—The management of the Sveriges Riksbank is entrusted to a Board of Directors consisting of 7 members, one of whom, the President, is appointed by the King, whereas the other six members are appointed by the Riksdag. The members of the Board are held responsible to the Riksdag. There is also a Parliamentary Committee on Banking which supervises the Bank.

THE COMMONWEALTH BANK OF AUSTRALIA ¹ :—The Commonwealth Bank of Australia is managed by a Board of Directors composed of the Governor (who is the chief Executive Officer of the Bank) and seven other Directors. These latter consist of (a) the Secretary to the Treasury, and (b) six other persons who are or have been actively engaged in agriculture, commerce, finance or industry. No director or officer of a banking corporation can be appointed to the Board. The Governor, the Deputy Governor and Directors specified in (1) are all appointed by the Governor-General. When the Savings Bank department of the Commonwealth Bank was separated from it and was established as the Commonwealth Savings Bank of Australia in 1927, the latter was placed under a Commission composed of a Chief Commissioner and two other Commissioners all appointed by the Governor-General.

THE BANK OF ESTHONIA :—As regards the Bank of Esthonia it was stated that although it has the legal status of a Joint Stock Company under State Con-

¹ Information very kindly supplied by the Governor of the Commonwealth Bank of Australia.

trol, the President and half the number of its Directors being appointed by the Government, in practice it is a pure State institution, all the shares being subscribed by the State. According to an amendment to the original regulations, "the Government of the Republic acts in the capacity of the General Assembly of the shareholders, as long as the shares have not changed hands."¹ The Board of Deputies with the Bank appointed by the Government consists mainly of representatives of agriculture, trade and industry.

¹ League of Nations: Memorandum on Central Banks (1924), Page 164.

CHAPTER X

THE RESERVE BANK OF INDIA AND THE IMPERIAL BANK OF INDIA

PART I.

Constitution and Functions of the Imperial Bank of India.

INSTITUTION OF THE IMPERIAL BANK OF INDIA :—Owing to the existence of the Imperial Bank of India, the establishment of a Reserve Bank in India presents problems which very few countries in the world have had to face. The Imperial Bank is already performing one or two functions of a Central Bank, and the question arises, should it not be turned into a Reserve Bank? To answer this question, it is necessary to have an estimate of its transactions since its inception and of its relation with the Indian Money Market.

The Imperial Bank of India was established by the Act (XLVII of 1920) at the end of 1920 through *amalgamation* of the three former Presidency Banks of Bombay, Bengal and Madras, and started its operations on January 27, 1921.

REASONS FOR ITS CREATION :—The forces particularly responsible in bringing about this amalgamation had their origin during the Great War. As bankers to the Government, the three banks had rendered great service to the Government with whom their relations became very intimate. The nature of the work done by them was almost the same, and in performing their work for a common master they had to work with greater co-operation and harmony amongst themselves than before.

The advantage accruing thereby both to the Government and to the banks could not be thrown away after the war. No advantage was to be gained by the three banks remaining rivals in commercial business and at the same time working in unity as regards Government business. Amalgamation was looked upon as inevitable. Moreover, it was realized that Government balances in the hands of a centralized institution could be better managed and could be used more effectively to help business and trade than if they were distributed among the three rivals. It was also feared that powerful banking interests in England would dominate Indian banking after the war and that for self-defence there was no other recourse but to amalgamate. Besides, consideration was also given to the country-wide development of credit facilities which would ensue as a result of the spreading of the branches of a central institution over the country.

ITS CAPITAL AND GENERAL SUPERINTENDENCE :—Its authorised capital, Rs. 3,75,00,000 consists of fully paid shares of Rs. 500/- each and the remainder consists of contributory shares of Rs. 500/- each, on which Rs. 125/- is paid up.

The general superintendence of the affairs and business of the Bank is entrusted to a *Central Board of Governors*, “who may exercise all powers and do all such acts and things as may be exercised or done by the Bank and are not by this Act expressly directed or required to be done by the Bank in general meeting.” The actual executive work is carried on by *two* Managing Governors who are appointed by the Governor-General after consideration of the recommendation of the Central Board” to hold office for such period as the Governor-General may direct. Under the *general control* of the Central Board

of Governors are Local Boards at Bombay, Calcutta and Madras where still the head offices are located. The Local Boards are *elected* by the shareholders on the local registers and enjoy certain powers of autonomy.

The Central Board at present consists of 16 Governors as follows :—

(a) Nominated by the Governor-General :—

- (i) *Two* Managing Governors ;
- (ii) not more than *four* other voting members who must *not* be officers of Government ;
- (iii) the Secretaries of the local Boards in Bombay, Calcutta and Madras ;
- (iv) The Controller of the Currency or such other officer as may be nominated by the Governor-General.

N. B. :—The Governors mentioned under (iii) and (iv) may attend all the meetings but are not entitled to vote.

(b) *Elected* by the shareholders :—

The Presidents and Vice-Presidents of the three local boards, numbering in all *Six*, so that *six* Government nominees and six representatives of the shareholders are entitled to vote.

GOVERNMENT'S CONTROL OVER THE BANK :—The general policy of the Bank is regulated by the Central Board and consists of functions (which are laid down by By-laws) such as the fixation of the Bank rate and the movement of funds from one part of India to another. But as half the number of the Board, including the Managing Governors, are appointed by the Governor-General-in-Council, the *de-facto* control of the Bank is in the latter's hands. And to make the control more effective in practice, it is laid down that "the

Governor-General-in-Council shall *have* power to issue instructions to the Bank in respect of any matter which, in his opinion *vitaly* affects his financial policy or the safety of the Government balances and that, in the event of the Bank disregarding such instructions, the Governor-General-in-Council may declare such agreement to be terminated." The Act also lays down that the Governor-General-in-Council may appoint such auditors as he thinks fit to examine and report upon the accounts of the Bank.

ITS CENTRAL BANKING FUNCTIONS :—
The Act also provided for an agreement between the Bank and the Secretary of State which is for a period of 10 years (from 27th January, 1921 when it was signed) in the first instance, which entrusted the Bank with the following Central banking functions :—

(1) All the general banking business of the Government of India was to be carried out by the Bank and it was to hold all the Treasury Balances at Head-Quarters and at its branches. The transfer of the treasury business to the Bank at all places where its branches are situated led

- (a) not merely to the abolition of the Reserve Treasuries and a centralization and fructification of the Government reserves ; but also
- (b) to a larger proportion of the Government balances being placed at the disposal of the Bank for assistance to the money market, than was the case with the Presidency Banks separately.

(2) Moreover, the entire management of the registered Public Debt and Securities for the time being of the Government of India and the Secretary of State was undertaken by the Bank for which its remuneration was fixed by the Statute.

(3) The Bank was also given the privilege to transfer

its funds (within India) through the Government Treasury Department *free of charge*. In return it was to transfer money between its branches for the public at rates controlled by the Government.

(4) Within a few years of its inauguration, the Imperial Bank undertook to establish and maintain not less than *100 New Branches* 'of which at least one-fourth shall be established at such places as the Governor-General-in-Council may direct.' In return *the Bank was to receive the use of the Government balances for which no interest was to be charged, by the Government for the first ten years.*

(5) To what extent the Bank acts as a bankers' bank is disclosed by Sir Norman Murray, late Managing Governor of the Bank in his evidence before the Royal Commission of Indian Currency and Finance 1926.¹ He stated, "most of the leading banks in India keep their accounts with us and we also conduct the clearing houses at places where there are clearing houses."

(6) It was also authorized to institute a branch (unlike the old Presidency Banks) in *London* and to borrow money in England for the purposes of Bank's business upon the security of the assets of the Bank, but not otherwise.

Certain other details concerning these functions will be taken up in the latter part of the chapter.

SPECIAL RESTRICTIONS ON ITS ORDINARY COMMERCIAL BANKING:—With the transference of the Government balances to the Imperial Bank of India, it followed as a natural consequence that certain restrictions should be placed on its general banking business. The Act *prohibited* the Bank :—

¹ In his reply to questions 9572-9580 Minutes of Evidence, Vol. IV.

(1) from making any loan or advance :—

- (a) for a longer period than *six months*, or
- (b) upon the *security of stock or shares* of the Bank,
- or (c) upon *mortgage* or upon the security or any im-
movable property, or the documents of the title
relating thereto (except in the case of estates con-
trolled by Courts of Wards mentioned in Part V
(c) of the Act ;

(2) from discounting or buying or advancing or opening cash credits on the security of any negotiable instrument of *any individual or partnership firm*.

Such business could only be done on the *several responsibilities of at least two persons or firms unconnected with each other in general partnership* ;

(3) from doing business such as discounting or opening cash credit on the security of any negotiable security having at the date of the proposed transaction a *longer period to run than six months*, or if drawn after sight, drawn for a longer period than six months ;

(4) from granting unsecured advances in excess of Rs. 1 lakh ;

(5) from dealing in *foreign exchanges*, except for the bona fide requirements of their own constituents for their personal requirements ;

(6) from opening accounts at the London branch for persons who within the previous *three* years were *not* the customers of the Bank in India or of one of the Presidency Banks.

PART II.

Benefits given by the Imperial Bank.

HOPES OF THE GOVERNMENT OF INDIA :-
In their despatch to the Secretary of State concerning

the scheme for the amalgamation of the Banks, the Government of India had cherished a hope regarding certain great benefits which it was expected to bring to India. That "in course of time we shall expect to see the new branches of the Imperial Bank attract a large amount of deposits from the general public." That is, they expected capital to be mobilized in India. They also anticipated that it would serve the purpose of a Bankers' Bank more effectively than the Presidency Banks because "it cannot be expected that the number of banks in up-country districts can be largely increased, or can be placed on a satisfactory footing, unless there is at their door a powerful bank to which a sound institution can turn in time of trouble and to which it can look for guidance in its general financial policy." They also hoped that the Bank would form a solid background necessary for the healthy development of the various forms of banking, agricultural, industrial and ordinary joint stock of which this country is admittedly in need. They also considered probable the increase in assistance which it would give, through the multiplication of its branches, to the internal trade of the country and through its relations with the indigenous banking. Besides, a larger proportion of Government balances being placed at its disposal, the Bank would give help to the money market in times of need. Finally, it would be an ideal school for the training of Indians in the science of banking.

HAS THE BANK FULFILLED THE TRUST?

An attempt must be made to show how far these hopes have been realized during the working of the Bank for the last nine years. But any such account could not be accurate in face of the limitation that the Bank does not publish a detailed account of its borrowings and lendings

nor are its authorities always willing to give such information.

The policy of opening new branches was followed vigorously until by the end of 1927 it accounted for 165 branches of the Bank in the country. The following table shows the relative increase.

Branches of the Imperial Bank of India.

| Before Amalgamation of Presidency Banks (in 1920) | By the end of 1927 |
|---|--------------------|
| 69 | 165 |

(A) *Mobilization of Private Capital*:—With the object of spreading the use of banking facilities and thereby attracting money which has hitherto lain dormant, the Bank has been allowing 4 per cent. on ordinary savings bank deposits and $4\frac{1}{2}$ per cent. on savings bank deposits of Rs. 10,000 and above fixed for 3 months. The result has been a substantial increase in deposits to the extent of Rs. 835 lakhs up to May 1925, as the following table will show.

Deposits at *new* branches (on 29th May, 1925).

| | In places where there is <i>no</i> other Bank | In places where there is other Bank | TOTAL |
|------------------|---|-------------------------------------|----------|
| | In lakhs | In lakhs | In lakhs |
| Savings Bank | ? | ? | 168 |
| Fixed deposits | ? | ? | 337 |
| Current deposits | ? | ? | 310 |

? Details not available.

But in estimating the increase one should not overlook the possibility of a part of this increase representing deposits which were already in the branches of other banks and which may have been transferred to the Imperial Bank of India.

However, if the *total private deposits* of all the head offices and branches of the Bank are considered, they show a marked *decline* in 1927 as compared with those of the Presidency Banks in 1920, as shown in the following table.

Deposits with the Imperial Bank of India.

| YEAR | Public (Government) | Private | TOTAL |
|--|--------------------------|---------------------------|---------------------------|
| 1920 (Before amalgamation of the Presidency Banks.) | R (1,000) 9,02,63 | R (1,000) 78,01,90 | R (1,000) 87,04,53 |
| 1927 | 7,20,23 | 72,07,22 | 79,27,45 |

This indeed is not an encouraging position, but it does not necessarily mean any failing on the part of the Bank. The reduction in private deposits may be due to general trade depression. It is argued by some bankers that "the only conclusion possible is that the commercial public is finding services of other banks more suitable."¹ But this conclusion ought to be reflected in an increase in deposits with the Indian Joint Stock banks. On the contrary, the accumulated deposits of the Joint Stock banks show a *decrease* from Rs. 73,48 lakhs in 1920 to Rs. 64,30 lakhs in 1927. The decrease in deposits may, therefore, be

¹ B. T. Thakur : Organisation of Indian Banking, Page 56.

attributed to a cause common to all banks of the country, namely, trade depression.

(B) *Discount of Bills* :—The second test of its usefulness can be seen in the discount of hundis¹ and other bills. By its ability to employ more funds in the discount of such bills, it should be in a position to irrigate the channels of internal trade to a substantially larger extent than was possible before 1921.

In Lakhs of Rupees.

| Year | Inland Bills discounted and purchased |
|-------------------------------|---------------------------------------|
| 1918 (Before amalgamation) | 4,85 |
| 1927 | 4,33 |

But as the above table shows there is actually a fall, although it is negligible in the discount business of the Imperial Bank of India.

(C) *Its influence on the rate of interest in the mofussil* :—The institution of branches of the Bank in various parts of the country would also be expected to bring down the rate of interest for borrowing and the rate for discounting hundis. If this were achieved, the Bank would be said to have justified its trust by benefiting in particular the producers of food-stuffs and raw materials in the inland districts. However small this benefit might be in the beginning, it would be useful in showing the concrete advantage to be obtained by spreading branches far and wide over the country.

The Imperial Bank rate is likely to affect the rate (1) of the indigenous banker and (2) of an Indian joint

¹ A *hundi* is an inland bill of exchange used by the indigenous banker in India.

stock bank if one existed in the station where the Imperial Bank opens its branch.

(1) *The indigenous banker's rates* :—In the absence of any official Statistics, it is impossible to show accurately how far and to what extent the rate of the indigenous banker is affected. But from personal inquiry made in various towns in the Central Provinces and Berar, some useful experience has been gained. In these places, the indigenous bankers have lost nearly 30 per cent. of their exchange (Hundiyan) business owing to the fact that the Imperial Bank has begun to discount *hundis* at a cheaper rate. The rates for discounting hundis have steadily gone down in these mofussil districts. But the influence on the rate for borrowing from indigenous bankers is not affected materially for two reasons :

(1) as the Imperial Bank has been placed under restrictions regarding its lending business, it is unable to lend freely in the mofussil ;

(2) the principle on which the indigenous banker does business is entirely different from that done by any joint stock bank. However, in certain inland towns where the Imperial Bank started advancing money on the security of produce, the indigenous bankers have been compelled to reduce their rates from nearly 14 per cent. to 9 per cent., although they have not been brought down to the level of the Imperial Bank rate for the reasons stated above. Besides, in certain towns where the Imperial Bank had not opened a branch, fears regarding its institution were entertained by many indigenous bankers. It is natural to conclude, therefore, that the possible opening of a branch has an indirect effect on the indigenous rate.

(2) *The rates of joint stock banks* :—But the institution of the branches of the Imperial Bank of India has had a

direct and substantial influence on the rates of other joint stock banks. Not only are such banks compelled by force of competition to bring down their rates near the level of the bank rate of the Imperial Bank of India in the town centres, but the effect has been reflected in neighbouring centres where the Imperial Bank had no branches. In the evidence given before the Hilton-Young Commission by Mr. A. Bowie, Manager of the Allahabad Bank, we find a typical example to illustrate this result.¹

One of the members of the Commission, Sir Purshotumdass Thakurdass, in his very searching examination of Mr. Bowie, made him admit that at Harpur in the Punjab, when the Allahabad Bank was the only institution there for a number of years, it used to charge as much as 10 per cent. on the security of wheat put in pits during the slackest part of the money market period, when the banks at Bombay and Calcutta would have been glad to invest it at 3 per cent. or less. But when the Imperial Bank started its branch at Harpur, the Allahabad Bank had to reduce the rate to the bank rate of 6 per cent. or 5 per cent. The experience at Harpur is typical of what has happened in all centres where the Imperial Bank of India has started a branch; and those banks which used to make large sums of money by way of charging high rates on loanable money have lost their business.

That the rate of discount of hundis has also tended to fall in the mofussil generally can be gleaned from the same evidence. The case cited by Mr. Bowie was that of another place, Hathras, where the rate of discount for hundis had to be brought down as soon as the Imperial

¹ Minutes of Evidence taken in London before the Royal Commission on Indian Currency and Finance, Vol. V, Q. 12053-12077.

Bank of India opened its branch there. But on being asked by the Chairman whether it was an unusual case, he said that, generally wherever they entered into competition, when the Allahabad Bank offered $7\frac{1}{2}$ per cent., the Imperial Bank offered to do business at the Bank rate of 5 per cent.¹ The general service rendered in this respect by the Imperial Bank of India to the poor cultivator was well expressed by Sir Purshotumdas Thakurdas who in his examination of Mr. Bowie said "less cost for discount of hundis means less cost of marketing the raw produce. The money the merchant got was cheaper, and to that extent he would be able to pay the cultivators a proportionately higher price." And this is so because competition among buyers of agricultural produce would, if they found discounting of hundis cheaper, naturally offer a proportionately higher price to the cultivator.

(D) *Remittance facilities* :—The extent to which the Imperial Bank of India has given the public every facility for the transfer of money between its local headquarters and branches at rates not exceeding certain maximum rates fixed by the Controller of Currency, can be seen from the statement given below :—

Demand Drafts purchased

IN LAKHS OF RUPEES

| YEAR | 1921 | 1922 | 1923 | 1924 | 1925 | 1926 | 1927 |
|-------------|-------|-------|--------|--------|--------|--------|--------|
| First half | 20,19 | 32,44 | 51,35 | 70,62 | 84,06 | 66,32 | 68,56 |
| Second half | 38,03 | 41,73 | 56,48 | 63,93 | 72,96 | 57,22 | 70,86 |
| | 58,22 | 74,17 | 107,83 | 134,55 | 157,02 | 123,54 | 139,42 |

¹ Royal Commission on Indian Currency and Finance, Minutes of Evidence, Vol. V, Q. 11870.

Drafts and Telegraphic Transfers paid.

| YEAR | 1921 | 1922 | 1923 | 1924 | 1925 | 1926 | 1927 |
|-------------|-------|--------|--------|--------|--------|--------|--------|
| First half | 42,97 | 54,60 | 58,11 | 70,36 | 85,93 | 92,36 | 79,29 |
| Second half | 43,39 | 52,03 | 57,13 | 71,37 | 88,01 | 79,12 | 76,57 |
| | 86,36 | 106,63 | 115,24 | 141,73 | 173,94 | 171,48 | 155,86 |

The above figures show a large progressive increase in the use made by the public of the facilities provided by the Bank and therefore a substantial curtailment in cash remittances.¹

(E) *Service as Bankers' Bank*:—Most of the leading banks of India keep their accounts with the Imperial Bank of India, which also conducts the clearing houses where they exist in different places. The following statement shows how far the Imperial Bank of India gave its service as a Bankers' Bank as at the last week in March 1925.

IN LAKHS OF RUPEES

| Deposits of Banks | | Advances of Banks | | | |
|-------------------|----------------|-------------------|--------------|-------------|-------|
| Current A/c | Fixed deposits | Bills | Cash Credits | Over Drafts | Loans |
| 6,56 | 1,06 | 22 | 45 | 54 | 4,06 |
| Total: 7,62 | | Total: 5,27 | | | |

(Deduced from Vol. II Appendix 48 of the Report of the Royal Commission on Indian Currency and Finance, 1926)

But the deposits and advances were distributed among Indian Banks and other banks as follows :—

¹ "The large drop in the figures for 1926, and the first half of 1927 reflected the general easiness of money and the comparatively small amount of finance required for the main export staples." Report of the Controller of Currency for the year 1927-28.

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IN LAKHS OF RUPEES

| | Indian Banks | Other Banks |
|----------|--------------|-------------|
| Deposits | 185 | 576 |
| Advances | 306 | 223 |

How far the Imperial Bank of India has actually performed its most important function as a Bankers' Bank, that of giving help to other banks in times of difficulty, is not easy to exemplify. Indeed on the eve of the failure of the Alliance Bank of Simla, it did come forward to avert the widespread panic, but "that was averted by the action of the Government of India who asked the Imperial Bank, on their guarantee, to put up 50 per cent. of the money required to pay off the creditors of the Alliance Bank."¹ There is another instance which could be considered publicly. Mr. B. Chakravarti, Chairman of the Bengal National Bank, said frankly before the Royal Commission that when he was in difficulty with regard to his small bank because there was a run, the Imperial Bank saved the institution ungrudgingly; so much so that the money was paid up by the Imperial Bank before the papers could be got ready.²

It is difficult to know what progress has been made during the last five years regarding the various functions illustrated above. The reputation of many institutions suffers from lack of publicity and the Imperial Bank of India cannot be an exception to this rule. It is no surprise then to hear allegations made against the Bank, in particular, of partiality on the one hand and unfair competition on the other.

¹ Mr. A. Bowie's reply to Q. 11849, Minutes of Evidence, Vol. V, Royal Commission on Indian Currency and Finance, 1926.

² Minutes of the Evidence, Vol. IV, Page 400.

Generally, it is not possible to expect the Imperial Bank to play the part of a true Bankers' Bank, for it is competing in each class of business in which the other banks are engaged. There is no obligation placed on the Bank under the Act which might compel the Bank to make advances against Government or other securities to other Banks. How could it fortify the Indian banking Organization when it itself is a competitor in business? In order to give this service, a bank must be *thoroughly impartial and independent* and not in competition with other banks. Can a bank be expected to go for assistance to another which is its rival in business? Far from that, it dare not apply for help in an emergency because the knowledge of the application would create want of confidence and would tend still further to weaken its position.

But, from a statement submitted by Sir Norman Murray (one of the Managing Governors of the Imperial Bank of India) to the Royal Commission, one finds that during certain months Bankers' borrowings from the Imperial Bank exceeded their balances with it. Accommodation must therefore have been secured by the banks from time to time, but this is not as a matter of right.

PART III.

Competition of Imperial Bank with other banks.

ITS COMPETITION WITH OTHER BANKS :-
Such being the business conducted by the Imperial Bank of India, we are faced with the problem of the competition it enters into with other joint stock banks. Mr. Bowie of the Allahabad Bank, in giving his evidence before the Royal Commission, analysed the special advantages which accrued to the Imperial Bank of India

as :—(1) its *superior prestige* as Government banker and (2) *free money* which it received from the Government. These special benefits, he said, had left the joint stock banks “defenceless against the operations of the State Bank, which means that they are not in a position to compete on equal terms.”

The superior prestige of the Bank had permitted it to attract deposits in increasing amounts at the expense of the other Indian banks. Not only were the banks prevented from collecting new money in the form of deposits but some of the existing deposits had actually been drawn into the Imperial Bank. The lending power of the banks is no doubt restricted to that extent. In a previous part of this chapter, this influence was traced statistically. The fact which is pertinent regarding this ‘pool’ of deposits by the Bank is that its prestige as a Government banker has enabled it to draw deposits from the public at $\frac{1}{2}$ to 1 per cent. *lower* rates than other banks.

But the special advantage of receiving *money free of interest* from the Government has enabled it to cut into the rates and thereby bring money cheaper to the borrowers in the up-country districts. Banks do business by borrowing money in the open market at competitive rates, but the Imperial Bank is not compelled to do so because it has the facility of getting free money from the Government which enables it to lend money on first class security at a *lower* rate than those banks which are borrowing in the open market. ‘They cannot get money cheaper, and if they increase their lending rate, they cannot get first class security.’

Besides, the Bank has been buying *hundis* at ‘unprofitable’ rates, because it is not banking on economic lines. The rates offered are so low that if other banks are com-

pelled to do the business at these rates, they have practically no margin of profit left to them. In fact, there have been cases, where in Mr. Bowie's words "the Imperial Bank has been doing business at below banking cost". If this were true, it would be clear undercutting which would be deplorable in the interests of banking in the country. In their memorandum on the Reserve Bank Bill, the Bank of Baroda limited, cited an example of keen competition suffered by other banks from the Imperial Bank, where the Imperial Bank discount rate for *hundis* from 20th July to 22nd December 1926 was 1 to $\frac{1}{2}$ per cent. under the Bank rate i.e., *1 per cent. to $\frac{1}{2}$ per cent. less than the rate at which the Bank was prepared to lend to other banks against Government of India securities.* This is true to a certain extent, but when the proportion of Government deposits to private deposits with the Imperial Bank is considered, the following facts arise :—

- (a) that Government deposits form only 10 per cent. of private deposits ;
- (b) that this proportion per cent. of Government deposits to private deposits has *not increased* since the inauguration of the Bank ;
- (c) that both Government and private deposits have actually *decreased* in amount.

The following statement¹ gives testimony to these conclusions :—

IN LAKHS OF RUPEES

| 31st December | Government or Public deposits | Private deposits | Proportion <i>per cent.</i> of Government deposits to private deposits |
|---------------|-------------------------------|------------------|--|
| | Rs. | Rs. | Per Cent. |
| 1920 | 9,02 | 78,01 | 11·6 |
| 1921 | 6,80 | 65,77 | 10·3 |
| 1922 | 14,15 | 57,00 | 24·8 |
| 1923 | 8,56 | 74,19 | 11·5 |
| 1924 | 7,50 | 76,71 | 9·9 |
| 1925 | 5,46 | 77,83 | 7·0 |
| 1926 | 6,45 | 73,89 | 8·7 |
| 1927 | 7,20 | 72,02 | 10·0 |

It is clear then, as the figures show, that the contention that the use of free money from the Government has put the Bank in a stronger position than it was before 1921 does not hold ground unless the public deposits given away as loans have a quicker turnover than before. However the fact is that competition, instead of being restricted to a few places, is now spread over a *greater number of points* than before, and it is more acutely felt because the Bank has opened branches in places where other banks were the *pioneers*. It is harming the *branches* of other banks doing the same class of business, whose fear is that they will be *driven out of the field* by the undercutting of the Imperial Bank and thereby deprive the public of that competition which is in its interest, or that the banks will be driven to take a *worse form of security* which would

¹ Deduced from the Statistical Tables relating to Banking in India—1927. (Government Publication).

mean charging a higher rate and making their business insecure. The total advances made by the Imperial Bank at the new branches up to March 1925 was nearly Rs. $3\frac{1}{2}$ crores and during the years that have followed the amount must easily have reached nearly Rs. 6 crores. This means, on the one hand, that the Bank has taken a good slice of the business of other banks, but on the other, it shows the extent of the benefit given to trade in the form of cheaper money in the mofussil.

There is no denying the fact that a general reduction in the rates is in the interest of the country. It is no small gain to the country that the cultivator and the trader are able to get a cheaper supply of money. But the other joint-stock banks feel that "if Government wished by conferring special privileges on a selected bank to benefit trade, then in fairness to the established banks, these benefits should have been made available to trade through all the banks with which the public had been accustomed to deal."¹

There is another aspect of this competition. Since the banks have not been left enough margin of profit, it is difficult for them to place money to reserves and thus they are not able to keep on expanding; on the contrary, the Imperial Bank has carried large sums of money to reserve and to their pension fund. Such was the argument put forward by Mr. Bowie before the Commission. How far this contention is valid can be proved statistically. The following figures show the growth in the permanent resources of the Imperial Bank as compared with those of its predecessor, the Presidency Banks, in 1920 :—

¹ Memorandum submitted by the Allahabad Bank, Ltd. before the Royal Commission of 1926.

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| YEAR 31st December | Paid up Capital lakhs | Reserve and Rest | Investment in Government and other securities | Dividend for the year |
|-----------------------|--------------------------|---------------------|--|--------------------------|
| 1920 | 3,75 | 3,78 | 14,24 | Per Cent. 19 5/6 |
| 1927 | 5,68 | 5,24 | 18,59 | 16 |

Thus, there has been an increase of nearly 30 per cent. in its total resources on the 31st December 1927.

On the other hand, the competition is subject to the restrictions which are placed on the Bank by the Act and it exists in only 65 per cent. of the branches. In defending the Bank's position before the Royal Commission, Sir Norman Murray put forward the plea that as the Bank could not by law advance money on one name or on the security of shares, it was handicapped in doing business and that this became a practical restriction because, "it was quite possible that a customer of good standing might wish to borrow either on his own name or on the security of shares and in such a case we should have to let the business pass us." But other banks do not do much business on a single name, although they do so on the security of shares. In regard to business of foreign exchange, if the Imperial Bank is prohibited by Law from doing it, the Indian Joint Stock banks have secured no gain in practice, as this business has been the monopoly of foreign banks in India. Then, as regards the contention that the Imperial Bank was getting the Government balances free and thereby getting a pool, he answered by stating that no account was taken of the fact that the Treasury work has been conducted by the Bank without payment, which "entails a considerable amount of work

and a very considerable amount of expenditure, both capital and current.”

In considering the balance of advantage to the Imperial Bank, two other facts have to be taken into account.

- (1) Payment for managing the Public Debt Office and
- (2) the facility for making inland transfers free.

The payment for the first has been fixed at Rs. 2,000/- per crore per annum i.e. 1/50 per cent. but the advantage depends on whether there is any surplus left over after the managing expenses have been paid for. As regards the second concession it can be said that the Imperial Bank has the balance of advantage. It is true that the rate of banks has been reduced from one anna per cent. on amounts of Rs. 10,000 and over to half an anna per cent. in order to encourage them to effect their transfers through the Imperial Bank, but for buying transfers which the Banks need the gain has not been tangible. It is a substantial gain to the man of small means who handles small amounts.

PART IV.

Should the Imperial Bank of India be developed into the Reserve Bank?

The main question arises whether the Imperial Bank of India, which possesses some of the characteristics of a Central Bank, should be developed into a full-fledged Central Bank or whether a *new* institution should be created to exercise the functions of such a bank.

Considering the functions of the true Reserve Bank which have been traced previously, if the Imperial Bank as it exists to-day is to be expanded into a Reserve Bank, the following fundamentals will have to be obtained.

- (1) The right of note issue will have to be entrusted to it.
- (2) It will be the *sole* custodian of Government reserves.
- (3) It will have to be placed *legally* in the position of a Bankers' Bank.
- (4) And it will have to be decommercialized.

The consequences which would result from this and the judiciousness of taking these steps will now be discussed.

ARGUMENTS FOR AND AGAINST DEVELOPING THE IMPERIAL BANK INTO RESERVE BANK :—Sir Purshotumdas Thakurdas, in giving his opinion regarding a *new* bank being started, wrote in his minute of dissent that “such a scheme would involve the existence of two banks working side by side, each supported wholly or in part, by the use of the Government balances. Whilst purely appreciating the reasons which have induced my colleagues to propose the creation of a new Central Bank, and recognizing that this is perhaps the ideal system in the special conditions in India, I am of opinion that the ends in view, for as far ahead as we can see, will be better served by developing the Imperial Bank of India into a full-fledged Central Bank.”

The same opinion was voiced by Pandit Madan Mohan Malaviya who in opening the debate on the Reserve Bank Bill in the Legislative Assembly, asked the Finance Member to tell him “if there is any other country in the world where the Government of the country supports two banks by its loans and by its cash resources and by giving them all the advantages in the manner in which the Imperial Bank of India and now the Reserve Bank are to

receive support now?"¹ In short, their objection was against the existence of two subsidized institutions working side by side in the country. But this objection has for its basis the apprehension that the Imperial Bank, with the additional advantages to be given to it as the Agent of the Reserve Bank, would be all too powerful, and would instead of developing banking destroy not merely the Joint Stock Banks but the small indigenous bankers also. Among the many who have written on the subject was the late Mr. B. F. Madon. In his note on the Bill he wrote, "How can small banks develop all over the country, when we have this giant, with some 16 crores of capital and reserves, competing with them? As if this was not enough, this giant is to be given many points against its weaker competitors."²

If in the past, the Imperial Bank of India has utilized the Government Balances and its own capital in a way which has hindered the progress of any other bank or has actually killed it by unfair competition, then the necessity for restricting and controlling its resources becomes absolute. The answer can best be given by the competing banks and those business men who have an intimate knowledge of the working of the Bank. Be that as it may, *the suggestions which are made in the next part of this chapter, with regard to the restrictions to be levied on the resources and activities of the Imperial Bank* without impairing its usefulness and the method by which its monopolistic advantages could be distributed among the various banks of the country, should tend to remove the fear of the giant eating up the other banking institutions.

It is contended that if the Imperial Bank is expanded

¹ Legislative Assembly debates, Vol. IV, No. 51.

² Note on the Reserve Bank of India Bill.

into the Reserve Bank, it need *not* be decommercialized. Such was the argument put forward by the *Statist*, an authoritative journal in finance in England, which in its issue of the 6th November 1926 wrote, "Nor can we accept the postulate that it would first be necessary to 'decommercialize' the Imperial Bank. That development would come in course of time, as far as it really became necessary, as it did in the case of the Bank of England. After all, the most successful banks of issue in Europe are also large commercial banks, operating a large number of branches. The Federal Reserve Banks of the United States cannot be described as commercial banks, but then there are no American banks operating a net-work of branches covering even one State, not to speak of the Republic as a whole."

In a previous chapter it was argued at length why ordinary commercial business should *never* form a part of the functions of a true Central Bank. The history of the development of the Bank of England is unique. That great institution has been built up through years on the basis of those *conventions* and that *conservatism* in finance which has had no parallel in the world. It is conventions which have built up the English political constitution and similarly conventions have been responsible for the growth of the Bank of England into its present position as the world's Bank. That great tradition has yet to be established in India before a comparison is made between the two banks.

But if the Imperial Bank was not decommercialized, it may be asked if it would not be doubly more powerful with both commercial and Central Banking resources at its disposal. Would it not be a 'super-giant' completely equipped, with its wings spread over various parts of the

country and with its intimate knowledge of the various requirements, ready to devour the other banks? When asked by the Chairman of the Royal Commission about the proposal to expand the Imperial Bank into a Reserve Bank, Mr. Cecil H. Kisch, Financial Secretary at the India Office, said, "I do not think it is a suitable thing or a helping thing for the satisfactory functioning of a Central Bank that the holder of the ultimate reserves of the country should itself be the vehicle through which credit is directly made available for firms and individuals."¹

Besides, would it be fit to serve as a Bankers' Bank if it is to be a dangerous rival to other banks? A rival institution with a complete monopoly from the State can never be expected to give help to its rivals nor can it be looked upon by the latter as their saviour in times of need. Instead, there may be suspicion and jealousy which would militate against the usefulness of the system.

The same is true with regard to its management of currency. Suspicion would reign supreme that the currency was managed to further its own interests rather than the interests of the nation.

Then the question of its efficient working is to be considered. Heaping all these functions on a single institution would make it too cumbrous and difficult a mechanism to wield. There would be the *gravest danger of insecurity* from the point of view of the whole banking organization of India. Mr. M. M. S. Gubbay, ex-Controller of Indian Currency, preached before the Royal Commission a self-denying ordinance on the part of the Imperial Bank in the matter of accepting the function of

¹ Minutes of Evidence before the Royal Commission on Indian Currency and Finance, Vol. V, Q. 11, 132.

note issue thus, "We will not do this business because it is not right that you should expect us to do it. It is not right from the point of view of India as a whole and from the point of financial interests of the country, that we who are engaged in branch banking, as a bank of deposit, as a custodian of Government balances, should take on all these commitments which you are throwing on us."¹ The advice of a man of such infinite practical experience of currency management as Mr. Gubbay should be the right line to adopt in this respect.

It is argued that instead of splitting up the Imperial Bank the purpose would be met if there were two *separate* departments of the Bank, the issue and the banking departments, the former being kept under statutory control and the latter left free to do the business. But this formal separation would not be enough. Both departments will have to be under a single authority and the risk involved could never disappear. Mr. Cecil H. Kisch put this very emphatically when he said before the Royal Commission, "We must have an absolute assurance that the Issue Department is never made the handmaid of the Banking Department and as the control of the Note issue involves, rightly, discretionary power, and the exercise of judgment and wisdom, one wants that those powers should be exercised under the most favourable circumstances for their proper discharge."²

The plea has also been put forward in support of the Imperial Bank being turned into a Reserve Bank that *eventually the pure Reserve Bank would have to be empowered to do commercial business, for it would not have sufficient work to make its existence profitable* and that

¹ Minutes of Evidence before the Royal Commission, Vol. V, Page 117.

² Minutes of Evidence, Vol. V, Page 67.

therefore it would not be imprudent to start with this commercial bank. 'As projected by the Commission,' wrote the *Statist*, 'it seems likely that the Reserve Bank of India will either have to enter into competition with the commercial banks, and itself become commercialized, or forego all hope of obtaining adequate control of the local money market.' In support of this, some have put forward the instance of the Reserve Bank of South Africa, which began as a purely Central Bank, and when it was proved that it had no customers to lend to, had to be permitted to do commercial work by alteration of the Statute. For instance, it is customary in South Africa to allow interest on deposits ; but we have the evidence of as high an authority as Sir Henry Strakosch that this provision has remained in the Bank Statutes, because the Bank could not offer the facilities which an ordinary commercial bank could. Even Sir Norcot Warren, one of the members of the Royal Commission, expressed the fear of a similar difficulty in the case of the Reserve Bank for India when he asked Sir Henry Strakosch "Just as in the case of the Bank of South Africa, who are we to lend to? What banks are we to lend to, rediscount their bills? There are only about three banks in India we might lend to. The Exchange Banks I suppose would not want to borrow ; there is only the Central Bank of India, the Bank of India, and perhaps the Punjab National Bank."¹ The answer is that lending of money in the form of rediscount is only one function of the Reserve Bank which goes to form a part of its profits. *There are other privileges too, such as the right of note issue, which would be sufficient to give a margin of profit to the Bank.* True, the Bank cannot be expected to do much rediscount

¹ Minutes of Evidence, Vol. V, Page 46.

business at least for some years but as it helps in the growth of banking in the country and therefore to discount business, in course of time it would get sufficient work in this respect.

Besides, the question of dividends becomes imperative only in the case of a Central Bank which is constituted on a shareholders' plan. If that is dispensed with the question would not arise. Obviously for a national institution the giving of dividends is entirely subsidiary to the main object of organizing and building up a sound banking system in the country.

The Indian Merchants' Chamber, Bombay¹ and others have put forth an amended scheme in which it was suggested that the Imperial Bank of India could be partially decommercialized by putting restrictions on its commercial business *in the Presidency towns* and the large commercial centres where the Joint Stock banks already exist, leaving it free to do the business in the branches. Such a proposal does not consider the immense difficulties and the intricacies which would arise in separating the business done in the branches from that done in the cities, and as Sir Basil Blackett put it before the Royal Commission 'it must be a question of originating business.'²

If one guesses aright, one of the reasons which have influenced many supporters of the scheme to turn the Imperial Bank into a Reserve Bank is probably the suspicion that in the conduct of its business 'favouritism' has been shown, or the fear that, as the shareholding and management of the Bank have been drifting into European hands, if left uncontrolled in its commercial activities the Bank would do harm to Indian interests. In the inter-

¹ Memorandum submitted by the Chamber on the Reserve Bank Bill of 1927.

² Minutes of Evidence before the Royal Commission.

ests both of the Imperial Bank and of Indian business the Central Banking Enquiry Committee should be empowered to scrutinize closely the transactions of the Bank with a view to remove these impressions. The Governor-General-in-Council can order such an enquiry to be made under Section 54 of the Imperial Bank of India Act. No business men who may have suffered injustice would be willing to come forward publicly to put their case, for fear of complete loss of any accommodation on the part of the Bank in the future. But if the enquiry is of a confidential nature, the object would be gained.

To conclude, the only possible way to convert the Imperial Bank into a genuine Reserve Bank is to decommercialize it, but it would be prudent to leave the Imperial Bank to do its pioneer work of developing branches in India and spreading banking in the interior of the country *without harming the other institutions by unfair competition* and to create an entirely separate institution to serve as a Reserve Bank. In his evidence before the Royal Commission, Sir Montagu Norman, Governor of the Bank of England said, 'I should prefer to leave the Imperial Bank with the business and traditions, which to a great extent it inherited from the three other banks, as far as possible unchanged. I believe the maintenance of the activities, the customs, the business of these three banks and their successor throughout India, and especially in remote India would be a great advantage to India ; and I should be sorry to suggest anything which would in any-way interfere with it.' It would, indeed be a tragedy in banking finance to decommercialize the Imperial Bank so as to convert it into a Reserve Bank. If that were done, who would take its place in ordinary commercial banking in the country? Should an edifice with a hundred

and sixty-five branches be demolished? Even if that were done, 'we will have a new Reserve Bank in the air and with the old Presidency Reserve Banks and their successor dropped out, nothing between the Reserve Bank up in the air and the Exchange Banks and the indigenous banks down below.'¹ The true remedy for any disease in the body of the Imperial Bank does not lie in decommercialization and making it a Reserve Bank, but in leaving it free to do its commercial work, regard being had to splitting among other banks the advantages it may be proposed to give it as the agent of the true Reserve Bank.

PART V.

Imperial Bank of India as the Agent of the Reserve Bank of India.

THE CHANGES TO BE MADE IN ITS FUNCTIONS:—Since the establishment of a true Reserve Bank has been agreed upon, it would be necessary to deprive the Imperial Bank of the various privileges of Central Banking functions at present performed by it. On the other hand, by the transfer of the Central banking functions to the new Reserve Bank, the Imperial Bank should be *freed from the restrictions* which on account of its hybrid nature are at present imposed upon it. The Reserve Bank cannot and *must not* open many branches for economic reasons already explained in another chapter. It will, therefore, gain in one respect and lose in another. Hence it cannot do without the services of the Imperial Bank as its agent in the performance of certain of its Central Banking transactions. For instance, the Imperial Bank, with its many branches studded over the country,

¹ Sir Alexander Murray in his speech in the Legislative Assembly on the 30th August, 1927. Legislative Assembly Debates, Vol. IV, Page 3684.

can best do Treasury work, which is already being done by it. In this respect its services are absolutely necessary, and it must be given some reward for them.

The more important provisions of the Bill are :—

(a) It must be authorized to enter into an agreement with the Reserve Bank to do Government business as its *sole agent* ;

(b) it is proposed to *remove the limitation* imposed upon the Imperial Bank

(i) in regard to its *internal* commercial business and also on the *foreign exchange* business which it may transact ;

(ii) in regard to the work it may transact at its London Office, and give specific powers to the Bank to open branches outside India.

These clauses will give the Imperial Bank complete freedom to transact general banking business unfettered by any checks or artificial hindrances, and will make it *more formidable* in competition with other banks.

(c) Since the Imperial Bank will have no direct relations with the Government, it is unnecessary for the Government to retain any measure of control over the operations of the Bank by the appointment of members to the Board. It is, therefore, proposed to remove the right of the Governor-General-in-Council to appoint such members. But his power to appoint auditors to examine the affairs of the Bank in case of necessity is proposed to be retained.

ITS REWARD AS THE SOLE AGENT :—In addition to the removal of restrictions on its commercial business the following pecuniary benefits are proposed to be given to the Imperial Bank :

(i) It is laid down that in consideration of its work as the Sole Agent, the Reserve Bank of India shall pay

to the Imperial Bank of India a *commission* calculated on the total of the receipts and disbursements dealt with annually on account of Government by the Imperial Bank. Such commission shall be $1/16$ of one per cent. on the first 250 crores of such total, and $1/32$ of one per cent. on the remainder.

This commission is calculated to work out to nearly Rs. 30 lakhs annually, but against this has to be balanced the expenditure which the Imperial Bank will have to undertake for executing this work. There must remain a substantial surplus over from this transaction, or the shareholders of the Bank would never agree to do the work. It may be noted that at present no such commission is given to the Bank.

(ii) On consideration of the loss sustained by the Imperial Bank in respect of non-paying branches, it is proposed to allow the following Government balances, provided that the Bank keeps open branches not less in number than those existing at the time the Act comes into force :—

- (a) during the first five years from that time 3 crores *free of interest* ;
- (b) during the next five years—2 crores *free of interest* and at the option of the Imperial Bank an amount not exceeding 1 crore at 2 per cent. per annum ;
- (c) during the next five years—1 crore *free of interest* and at the option of the Imperial Bank an amount not exceeding 2 crores at 2 per cent. per annum ;
- (d) during the last five years—at the option of the Imperial Bank an amount not exceeding three crores at 2 per cent. per annum.

If these privileges are accepted fully by the Imperial Bank, during the 20 years the total gain to the Bank would be as follows, *calculated on the assumption that the money is loaned out by the Bank at an average rate of five per cent.*

| Period | Profits per year | Profits for 5 years |
|--------|------------------|---------------------|
| | Lakhs | Lakhs |
| (a) | 15 | 75 |
| (b) | 13 | 65 |
| (c) | 11 | 55 |
| (d) | 9 | 45 |
| | | Total <u>2,40</u> |

The above figures work out to an annual average of Rs. 12 lakhs.

On the other hand, the monthly average of the cash balances of the Government in the Imperial Bank, during the years 1925-26, 1926-27, 1927-28, was Rs. 15 crores. There is no doubt that under the new arrangement the Imperial Bank will lose considerably by not receiving free money from the Government. But how long is the subsidy proposed to continue? For fully 10 years the Imperial Bank will have advantage of it, and why should the same benefit be not distributed among other Indian Banks? Such is the claim put forward with reason by other Banks—that “if with Government moneys and all resources and benefits at its disposal, the Imperial Bank is making losses at some of its branches and Government are prepared to go to its help and compensate it, why should they not do so in the case of indigenous banks?”¹

¹ Letter of the 7th March, 1927 addressed jointly by the Allahabad Bank, the Punjab National Bank and the Central Bank of India.

In putting the case for the Imperial Bank of India before the Royal Commission, Sir Stanley Reed said, "One hundred new branches are a drop in the ocean; when the Imperial Bank has opened 5000 new branches, then they may consider that they have made some substantial step towards the proper organization of Indian credit. None of these branches can pay for years. How is the Imperial Bank to carry this baby if it is to be deprived of the advantage of a free use of the Government branches?"¹ This is perfectly true. But the point at issue is not whether the Imperial Bank should be given the subsidy of free money, but whether it *would be just to give other banks some share in it*. Instead of allowing the Imperial Bank Rs. 3 crores during the first five years, let it have, say, Rs. 6 crores, but at least let half that amount be given to other Indian Banks.

WHY SHOULD OTHER BANKS NOT SHARE THE PRIVILEGES? Under the present circumstances, it is not possible for the Government to give some part of their balances free of interest to other Indian Banks for the specific reason that Government has no hold on them and that therefore there is great risk involved in such a procedure. But by the Act which will bring into existence the Reserve Bank of India, the other Indian banks will gain recognition as 'scheduled banks' and will be brought within the fold of the Reserve Bank. Besides, some part of the Reserves of these banks will have to be deposited with the Reserve Bank *compulsorily*, and with additional regulations introduced, and special conditions laid down with regard to the acceptance of free money by the other banks, the risk involved in spreading some part of the Government balances would be minimiz-

¹ Minutes of Evidence before the Royal Commission, Vol. V, Page 248.

ed and instead of a single institution growing like a monster into 5000 and more branches, its load of profits would be shared by other banks. And why should the benefit be confined merely to Indian Joint Stock banks and not be distributed proportionally among the Co-operative Banks and indigenous bankers also?

A SCHEME PROPOSED :—All interests must receive fair treatment and some scheme must be evolved which would make this practicable. In the first place, the Government balances may be distributed *free of interest* for the first five years in some such proportion as follows :—

| Class of Banks | Amount to be given <i>free</i> of interest |
|---------------------------------|--|
| | Crores |
| 1. Imperial Bank of India . . . | 4 |
| 2. Indian Joint Stock Banks . | 2 |
| 3. Co-operative Banks* | 2 |
| 4. Indigenous Banks* | 1 |

* Details of these banks are considered in subsequent Chapters.

The amount to each class of banks may be increased after five years, if found successfully used.

Secondly, special conditions must be laid down for giving the above amount free of interest to the Scheduled banks.

(i) It should first be given to those banks which have already established a branch or branches for at least 3 years. Existing branches must be helped first.

(ii) The amount to be allocated among the various banks must be made to depend upon the business already done by their branches and the bank must show all the accounts of the branch or branches to the Reserve Bank before a demand is made.

(iii) The amount received from the Government should only be loaned *on first class or other approved security*.

(iv) The statute should lay down the *maximum rate of interest* at which this amount could be loaned to (a) agriculture (b) commerce and (c) small industries.

(v) There should be a time limit placed on the loans, say, six months for commerce and 9 months for agriculture and small industries.

(vi) And all accounts concerning the Government money should be clearly shown to Reserve Bank authorities.

Thirdly, the bank receiving the advantage must do Treasury work for the Government.

Fourthly, the Reserve Bank of India, must have an administrative committee called the "Rate Fixation Board" to control and manage this part of banking—the development of branch banking in India.

It would be prudent to see how the scheme has worked and what advantage has been taken of it by the scheduled banks during the first five years before further legislation is laid down for the future.

ADVANTAGES OF THE SCHEME:—The scheme would permit Rs. 9 crores of Government balances 'to nourish and to develop and dry-nurse the internal credit of India'¹ *without imparing their safety*. Besides, the limitations under which they are to be used would not lead to any 'dissipation' of the Government balances by being scattered over the various banks. They could be mobilized as quickly as the money loaned by rediscount and other operations of the Reserve Bank, because all these operations would have practically the

¹ Sir Stanley Reed in his Evidence before the Royal Commission, Vol. V, Page 248.

same time limit. The Government would suffer no loss because in the past they have been accustomed to carry 15 to 16 crores every month free of interest. The Imperial Bank would not be unfairly treated for it would get double the amount of the scheduled banks, and the 'uneconomic' competition seriously complained of by the other banks would be mitigated. The Treasury work would also be done by various scheduled banks, and the Government balances would be managed more efficiently. There would be no innovation introduced in this respect. Even in the Scottish banking system before the Great War, "the Collector of Revenues and Excise of the Government used to keep accounts in rotation at different Scottish Banks."¹ And the prestige of the Scheduled banks as Government bankers would increase and their credit would develop.

If the scheme of distribution is found to have worked successfully during the first five years, it could be continued with advantage and larger sums loaned out without interest in the future.

¹ Mr. A. Bowie in his Evidence before the Royal Commission, Vol. V, Page 104.

CHAPTER XI

THE BANK RATE OF DISCOUNT IN INDIA

The Bank rate in India may, at this stage, be considered.

NO DISCOUNT POLICY IN INDIA :—In India, there is a 'Bank rate' but no *Bank rate policy*. This is so for three principal reasons : In the absence of a Reserve Bank (a) there is no co-ordination of currency and credit because, as stated above, the Government controls currency, whereas the Imperial Bank 'controls' credit ; (b) there is no mobilization of reserves on the basis of which a credit policy could be made effective and (c) there are, so to say, two different Money Markets in India, those of indigenous bankers and the Joint Stock banks.

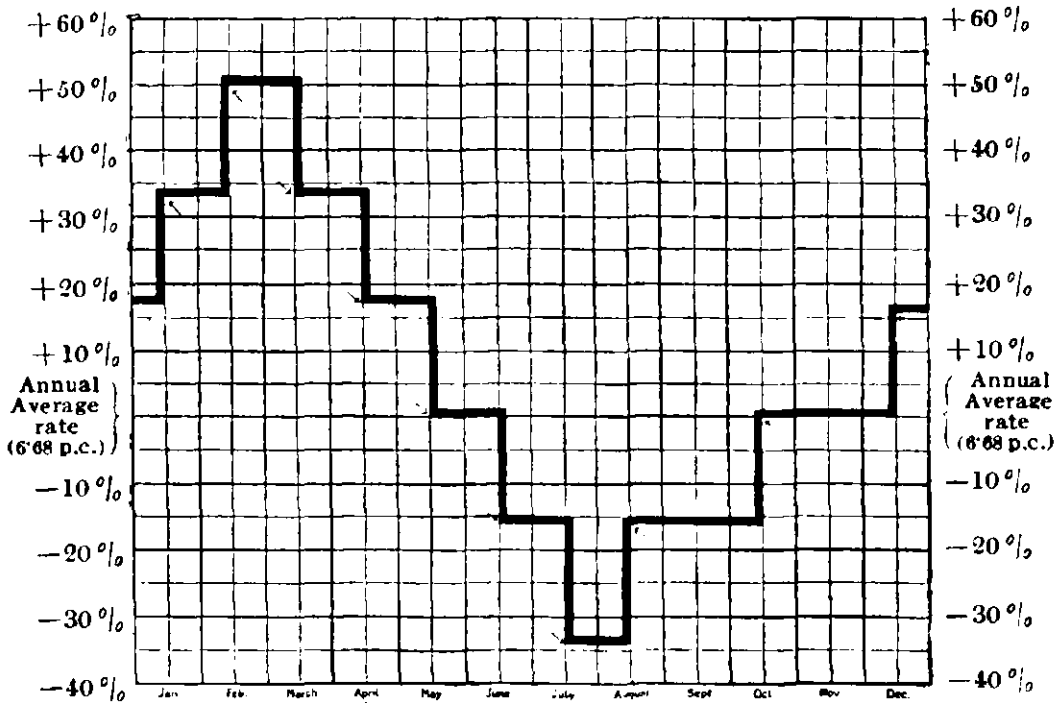
But the Bank rate, as it is understood in India, is *not* the same as the rate of discount which exists in countries with a Central Bank. Officially, the Bank rate is the rate at which the Imperial Bank of India will ordinarily *advance* money *against Government securities*, while the Imperial Bank *Hundi rate* (A Hundi = a Bill) is the rate at which the *Imperial Bank will discount or rediscount first class three months' bills*.

CHARACTERISTICS OF THE DISCOUNT RATE IN INDIA :—The chief peculiarities of the discount rate of the Imperial Bank may be stated. The Indian money market is very unsteady and suffers from :—

- (1) a *high maximum* rate of discount,

- (2) fluctuations in the discount rates which are great and rapid during the year and
- (3) the marked difference which exists between the maximum limit and the minimum limit of the rate.

These characteristics are at once noticeable from the following diagram :—

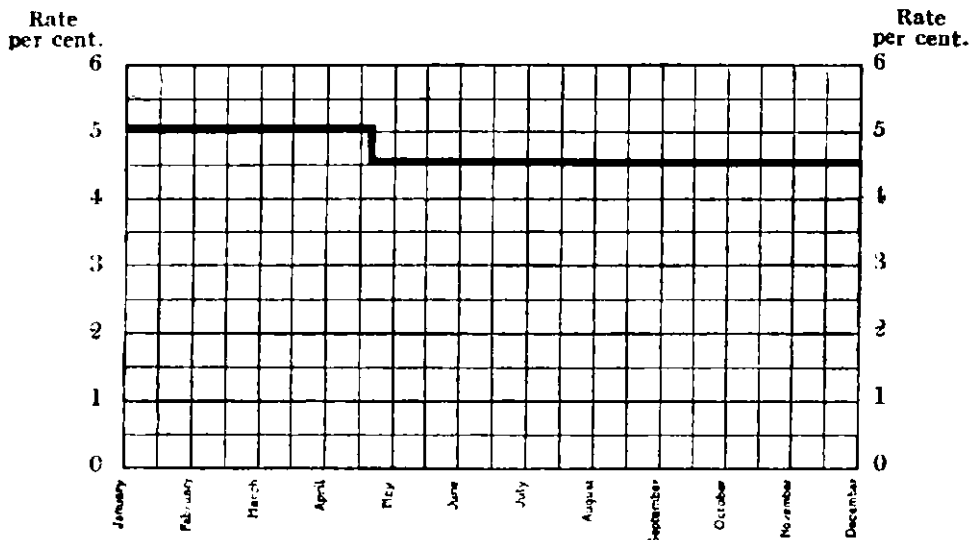


Discount Rate of the Imperial Bank of India during 1924.

The diagram shows that the maximum rate of discount during the year was 50 per cent. above and the minimum rate was 33 per cent. below the annual average rate of 6.68 per cent. Such a wide difference, +50 per cent. and -33 per cent., is probably unheard of in any other country. During the year, the maximum rate of discount was 9 per cent. and the minimum 4 per cent. In the pre-war year 1913 the maximum rate was 8 per cent. in February and 3 per cent. in August.

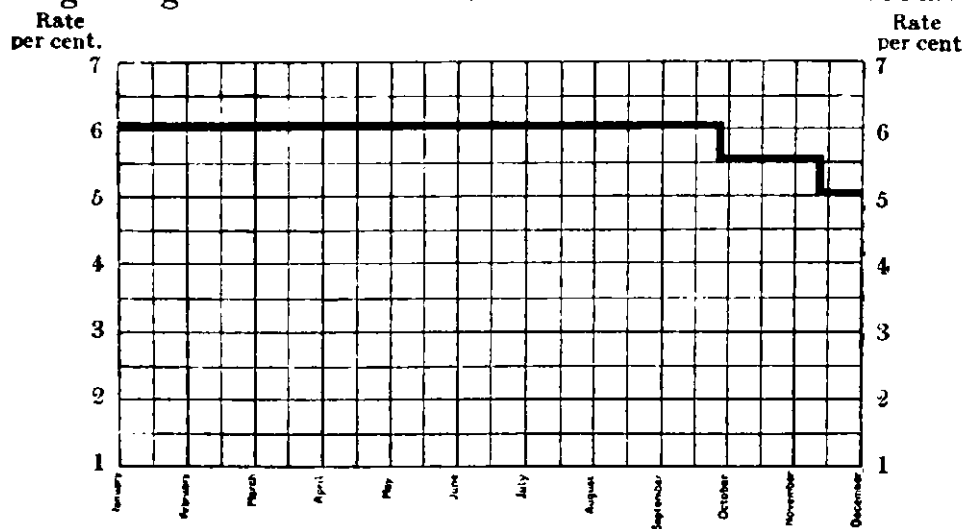
Further, the rate of discount *was changed 10 times during the year 1924* as the arrow heads show.

One is tempted to compare the typical variations in the rate of discount in India with those in countries having a Central Bank.



Discount Rate of the Bank of England (during the year 1927).

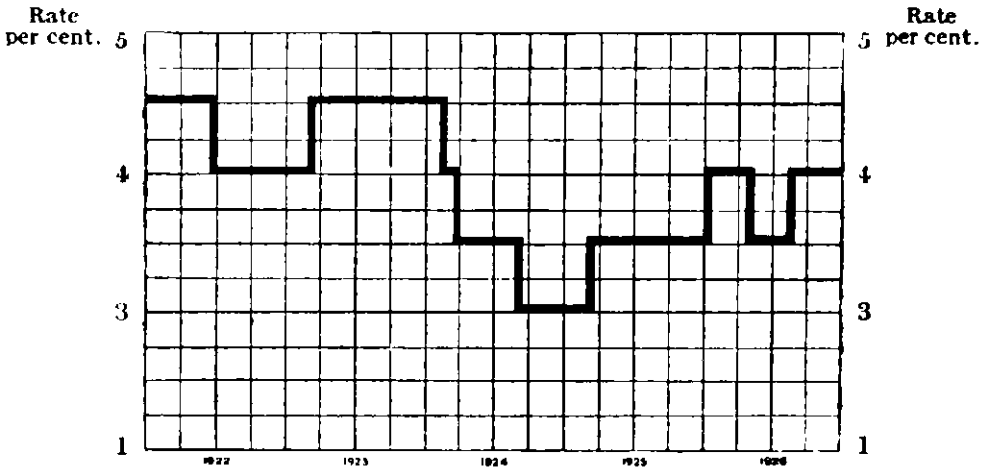
The foregoing diagram illustrates the remarkable steadiness of the rate of discount of the Bank of England, which was changed only once during the year 1927. The diagram given below shows the variation in the discount



Discount Rate of the Reichsbank (Germany) during the year 1913.
(Information very kindly supplied by the Reichsbank authorities.)

rate of the Reichsbank (Germany) which was changed twice during 1913.

How very infrequently and within narrower limits the rate of discount changes when it is controlled by a Reserve Bank can best be illustrated from the case of the United States of America.



Discount Rates of the Federal Reserve Bank of New York during five years.

The above diagram indicates two startling facts. In the first place, during the five years the Federal Reserve Bank of New York changed its discount rate only 9 times or less than twice a year on the average, and secondly the variations were throughout these years between the narrow limits of $4\frac{1}{2}$ per cent. and 3 per cent.

THE CAUSES OF FLUCTUATIONS:—The extraordinary fluctuations in the rate of discount in India are due to various factors. The first place is given to the normal seasonal stringency. In India, a predominantly agricultural country, there is a busy season when the volume of cash required for harvesting and moving the crops is at its maximum, and there is a slack season covering nearly three months of the monsoon during

which the demand for cash is at its minimum. 'The Monsoon' said Sir Basil Blackett, 'thus increases the wideness of the margin between the amount of currency and credit required when activity is at its minimum during the year.'¹ In laying stress on the inevitability of monetary stringency he also said in the same speech 'stringency in the money market has its roots in the facts of nature.' He could well have added that it had its root in the *unnatural system* of adjusting the supply of currency to meet the demand for it. India is not the only agricultural country where seasonal stringency exists. The United States of America and Australia are also large agricultural countries but their currency and banking organizations are so well managed and controlled by their Reserve Banks that seasonal stringency has its least effects. In the absence of a Reserve Bank, no short-term credit could be created to give elasticity to the currency during the busy season. In India, as stated previously, the divorce between credit and currency is the fundamental cause which leads to a *maladjustment* of the supply of currency to meet the country's requirements and it is no wonder that the bank rate rises and falls abnormally and frequently during the year. This also leads to a want of elasticity in the system necessary in a country like India. Besides, in the absence of a true Bankers' Bank to centralize the banking reserves of the country, money cannot be mobilized to be pumped into the needy channels of the country quickly and effectively. Credit cannot be built up sufficiently with the banking reserves kept separately with the banks and with enormous sums of money in the Paper Currency and Gold Standard Reserves locked up with the

¹ His speech while performing the opening ceremony on July 24th 1924 of the Branch of the Central Bank of India, Ltd. at Calcutta.

Government, which could without fear be used to a considerable extent to help Indian business and trade during the busy seasons.

ISSUE OF SEASONAL CURRENCY :—The system at present in force for the issue of *seasonal currency* during the busy season consists, as stated previously, of the power given to the Government by law to advance to the Imperial Bank of India currency notes up to the maximum limit of *Rs. 12 Crores* under the following principal conditions :—

- (a) This advance is to be against *internal bills* or *Hundis* drawn for *trade* purposes.

Such trade bills shall remain in custody of the Bank as securities held on behalf of the Currency Department.

- (b) No loan shall be made until the Bank rate rises to 6 per cent.

- (c) The entire amount outstanding at any time shall bear interest at Bank rate subject to a minimum limit of *6 per cent. for the first four crores* and of *7 per cent. for the subsequent eight crores*.

The Bank is entitled to deduct from the amount of interest payable any amount it had to pay for stamp duty on *hundis* held by it on behalf of the Currency Department.

- (d) The Local Head Office of the Imperial Bank at Calcutta will present to the Controller a demand promissory note for the amount taken on loan.

In order to introduce much needed elasticity, there is also a provision (according to the announcement of September 1924) that as far as might be necessary, Government “would use their powers to issue currency against *Treasury Bills* deposited in the Paper Currency Reserve

in London and would, if necessary, introduce legislation to increase the legal limit of the holding of securities in the Paper Currency Reserve." And this was acted upon for the first time in February 1925.

Thus, there is a two-fold mechanism for the issue of emergency currency.

It may well be asked whether the system of seasonal expansion of currency has worked well and provided adequate facilities to business and trade. The main difficulty experienced by the Imperial Bank in working this system has been in finding a sufficient quantity of domestic *trade hundis* for the purpose.¹

Normally, the amount of these genuine trade hundis which the Imperial Bank receives during the busy season is 40 to 45 per cent. of the total required under the arrangement. The rest is met by inducing firms which have hitherto financed themselves by cash credits, which is the old and firmly established method of advancing in India, to finance themselves by bills in place of cash credits, "which were in effect bills substituted for cash credits."² The bills manufactured by transfer from cash credit account have served the purpose satisfactorily. For, as Sir Norman Murray said before the Royal Commission, "the business which is behind these advances is the business which does create the true seasonal demand and that the advances do gradually liquidate themselves. Take, for instance, jute. The advances are granted in the early part of the year and gradually run off as the stocks are manufactured towards July when they are completely liquidated."³ But in order that encouragement would be

¹ This subject has been dealt with in Chapter XIV.

² Controller of Currency, in reply to question 995, before the Royal Commission on Indian Currency and Finance, Vol. IV.

³ In his reply to Question 9657.

given to the creation of larger number of bills Sir Norman Murray suggested a considerable reduction in the stamp duty on these bills.

But can the vast seasonal monetary requirements of a mainly agricultural country like India be adequately satisfied by temporary expedients, such as the issue of emergency currency to the extent of nearly Rs. 12 crores? Is it possible for such an expedient to bring about a relatively stable rate of discount throughout the year? The experience of the working of the system during the last eight years has shown that although its benefits cannot be denied, it has at best proved a palliative. Even after its institution, the high maximum rate of discount has continued and there is no appreciable change in the fluctuations in the discount rate during the year. So that the system of emergency currency is nothing short of 'a policy which trifles with the system instead of eradicating the disease.'¹ The real remedy lies in the institution of a Reserve Bank which shall have the power to issue and control paper currency, freedom to wield its instruments of credit policy and mobilize the reserves of the country.

¹ Wadia and Joshi: Money and Money Market in India, Page 415.

CHAPTER XII

A BILL MARKET FOR INDIA

In the matter of adaptability to changed environment in business practices no country has greater claims to the admiration of a student of economics than the United States of America. Before the year 1913 this country had no 'bills' and no 'bill market', but with the inauguration of the Federal Reserve System in that year both these were born and with surprising rapidity they grew until to-day the money market in the United States has an unrivalled position in the world of business, excepting Great Britain. In giving evidence before the Royal Commission, Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, said, "I say that the proper functioning of a Central Bank will require a money market in which it can function. *It may not be necessary to create that in advance*. We had no bankers' bills in New York when the Federal Reserve Banks were established. As a necessary and collateral development of the operation of a Central Bank it would be well to promote the development of a type of money market in which that bank would easily function." It is not hazarding blind optimism to state that what the United States has done, India can do gradually during a much longer period. But a beginning has to be made. Before the possibility of a bill market in India can be explored, it is necessary to understand which kind of bills is used in the United States, what exactly are the essentials of the system, how it works in actual practice and whether it could be introduced in India. This credit instrument is known as a

“Bankers’ acceptance” (or ‘Bankers’ bill’). As defined by the Federal Reserve Board, a banker’s acceptance is “a bill of exchange of which the acceptor is a bank or trust company, or a firm, person, company or corporation engaged in the business of granting bankers’ acceptance credits.” There are many kinds of bank acceptances prevalent, but their principal purposes are :

- (1) to finance the movements of imports and exports of commodities ;
- (2) to finance the *domestic* movements of goods at home or abroad.
- (3) to finance the staple commodities, particularly farm products held in warehouses, under certain restrictions ;
- (4) to create dollar exchange, under certain restrictions.

How is the bank acceptance created? The following simple diagram illustrates the creation and service of a bank acceptance *in domestic movement of goods*. The example taken has reference to India on the supposition that a Reserve Bank is established.

THE CREATION OF THE ACCEPTANCE :—
 Suppose a dealer X in Lahore has sold 100 bags of wheat to Y in *Bombay*. Y arranges to receive a guarantee (called “Letter of Credit”) from his bank B in *Bombay* that it would accept a draft drawn on it *by X* for the value of the wheat on a specified date, say 3 months, with the necessary documents attached and convinces X with a letter from his banker B agreeing to accept a draft from him. Thus Y receives *credit* from his bank B for the value of the wheat for 3 months. It is important to remember that *what the accepting bank lends is credit and not funds*. As soon as X receives this promise, he

draws a draft on Bank B and discounts it with his bank L in Lahore which forwards it to bank B to Bombay. The bank B puts its stamp 'accepted' on the face of the draft

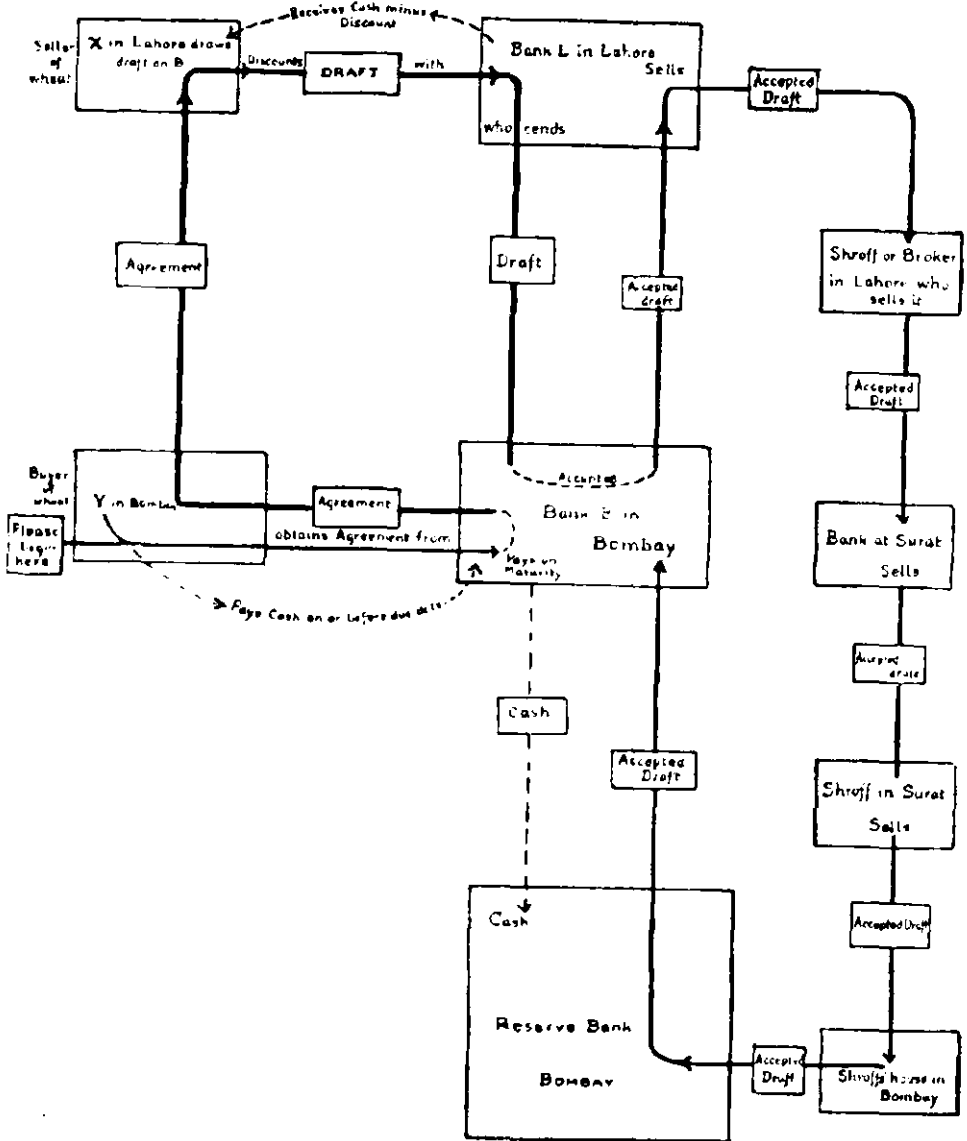


Diagram showing the creation and working of a Bankers' Acceptance.¹

and receives a railway document showing that the consignment of 100 bags of wheat has been sent by rail to

¹ The plan is adapted from Burgess: The Reserve Banks and the Money Market.

Y from Lahore. The accepting bank B keeps the railway document in its own possession. Y on his part has agreed to pay the amount on or before the specified date into the bank B.

HOW IT IS MADE NEGOTIABLE :—This accepted draft becomes a bankers' acceptance and has a ready market for sale. As soon as the bank L in Lahore receives the *accepted draft*, it sells it to a broker or shroff in the same city. The shroff in his turn sells it to another bank in a different town, Surat, which in its turn sells it to a shroff who re-sells it to a Shroffs' House in Bombay. The Shroffs' house sells it to the Reserve Bank which keeps the bill on its portfolio until it has matured, when it is presented to the accepting bank for payment and either cash is obtained for it or its account with the Reserve Bank is debited accordingly. Before this acceptance is paid for by the accepting bank B, Y must have paid the amount into B which has given him credit.

ITS ECONOMIC ADVANTAGES :—The advantages derived from the use of the bank acceptance will now be analysed in order to show why it is the *highest type* of commercial paper. In the first place, the seller of wheat X is enabled to get his money *before the wheat* is actually delivered to Y the buyer. Y would not pay him until he has received the consignment. Without the acceptance the seller X is compelled to wait for his money and as a consequence (i) he is hampered in his business by his capital being tied up for the period, particularly if the distance is great or transportation is slow. (ii) And if he is forced to borrow money from his bank L to finance the transaction, it would be a more costly business if trade were active and the giving of a direct advance

would depend entirely on the cash position of the Bank. (iii) Besides, the difficulty to X would be financially still greater if the bank L happened to exist in a place where loans are highly seasonal.

But the use of bank acceptance eliminates these difficulties.

Secondly, the point which needs special emphasis is the fact that as the draft carries on it the guarantee of a bank (B in the example) and not merely of an individual, it becomes a *perfect security* and the bank L is not merely completely willing to discount it but does so at a *lower discount* than on another document like an ordinary bill of exchange. The advantages which bankers' acceptances give to business men are, therefore, *ready money* and *cheap money*.

Thirdly, as stated above, what the accepting bank B lent to Y, the buyer of wheat, was not money but merely *credit*. The amount of credit extended in the form of an acceptance, therefore, *did not depend upon the amount of cash on hand* with the accepting bank, as would be the case if a loan of money were given by it. So that the *loaning capacity of the bank is considerably increased*. And as the business man Y agrees to have the money ready *at or before maturity* of the acceptance, he is permitted to *turn over* his business oftener. And every time a new business is transacted by Y he is given the same facility of credit by the bank and not a renewal of credit for the old transaction. In this way, the bank keeps itself safe and gives liquidity to its acceptances.

Besides, since the accepting bank has not parted with funds immediately but has given merely credit, it is satisfied with a very *small commission* for the service

undertaken on behalf of his customer Y who, therefore, gets credit at a minimum of expense.

Fourthly, Bankers' acceptances, are *self-liquidating* for two specific reasons ; (a) they are endorsed by a *bank* which offers its whole assets as security and (b) they are based on particular transactions which are *scrutinized* by the accepting bank and therefore are a certain guarantee of their maturity. For these reasons, they are most readily negotiable and command a *lower* rate of discount in the market than other short-time paper.

Fifthly, because of their ready negotiability they can be made to go from institution to institution and from place to place *quickly, and without any risk of refusal*. Bankers' acceptances, thereby, are the best instruments for connecting one money market centre with another. In the simple illustration given above the acceptance travelled over three centres Lahore, Surat and then Bombay. And the larger the number of places through which Bank acceptances were made to circulate, the wider and more uniform becomes the acceptance or the bill market in the country. But its great service is in connecting a *mofussil* or *country* money market with the central *city* money market.

I. THE 'AGRICULTURAL PRODUCERS' BILL :—Another example will now be chosen to show not only the importance of bank acceptance in financing the producer for the *movement* or *storage* of *crops* but also as a *connecting link* between the country money market and the city money market.

Suppose a Co-operative Sales' Society of a country place, Kim (nearly 15 miles from Surat) has 100 bales of cotton for sale but wants to store it in a warehouse until better prices prevail in the market, say for 3 months.

The Society then draws drafts of the total value of the cotton on the Acceptance Association payable in three months and takes them with the warehouse receipts for storing cotton to the Association, which takes possession of the warehouse receipts as security and returns the drafts duly endorsed with the word "accepted" on the face of them (as was shown in the previous example). To repeat, what the accepting bank lends immediately is *credit* and *not money*.

The Co-operative Sales' Society then discounts the accepted draft with the Co-operative Central Bank at the nearest place, Surat, and for reasons explained in the previous example, is able to discount it *immediately and cheaply*, say, at 3 per cent. per annum. As soon as this is done, the principal service desired of an accepted draft is rendered by it, i.e., the Co-operative Society has received finance quickly.

The Society goes on paying to the Acceptance Association as cotton is sold, until on maturity they pay them fully for the accepted draft and also some commission, say 2 per cent. per annum, for having lent their credit to them for three months. On the whole, therefore, the Society has obtained the finance at 5 per cent. (3 per cent. for discount and 2 per cent. for credit) which indeed is the cheapest way in which it could have done so.

Then, the Co-operative Central Bank sells the accepted draft, say, to a Shroffs' House (Brokers' House) which in its turn sells it to, say, a Discount House in *Bombay*. The Discount house may sell it to any Bank in *Bombay* which may sell it again to the Reserve Bank. The accepted draft is kept by the Reserve Bank on its portfolio until it is presented on maturity to the Acceptance Association for payment and cost *obtained* for it. If,

however, the 'Acceptance Association' instruct their bankers, the Bank of India, Ltd. in Bombay to pay on their behalf for the accepted draft, the process would be better. The Bank of India Ltd. would pay cash to the Reserve Bank and debit their clients' account accordingly. But in the ordinary course, with the establishment of the Reserve Bank it will have on its special portfolio a complete list of recognized credit associations, like the Acceptance Association of Kim in the example, and also of their bankers. So that the Reserve Bank has not to send the accepted draft to Kim to the Association, but has to hand it over straight to the Bank of India Ltd. in which case it would necessitate simply a book entry.

As soon as the ultimate buyer, the Reserve Bank, is paid for buying the accepted draft, the central money market (Bombay) is brought into connection with an up-country bankless place, Kim. *The accepted draft has thereby performed its second useful function—that of linking Kim with Surat and Bombay*, and a common market, the 'Bill Market', is established. This point may be developed little further to show its true merit.

The accepted draft has acted like a dredger. It has gone from place to place digging a continuous canal, however irregular it may be in geographical design, until it has reached its desired place, the central reservoir, the Reserve Bank. As soon as it has dug a canal joining the Reserve Bank, water (money) flows *out of it* in a limited quantity. And as the accepted draft continues its course and reaches its ultimate destination (in the example, the Bank of India, Ltd., Bombay), a limited quantity of water (money) is made to flow *into* the central reservoir, the Reserve Bank. (This has been explained at length in the chapter on 'Rediscount').

A RESERVE BANK'S GUARANTEE IS NECESSARY :—This emphasizes the absolute necessity of the existence of a central reservoir, the Reserve Bank. No dealer in drafts or bills, be he a shroff, a Shroffs' House or a bank, would ever be willing to buy this paper unless he has the absolute guarantee of some body or institution *always ready to buy it from him* when offered to do so. *A Reserve Bank supplies this guarantee. It is ever ready to buy accepted drafts or bills, be they from dealers or banks, at its current rate of discount.* These dealers or banks who purchase this paper have complete confidence that if there is no one to purchase it from them, they can always sell it to the Reserve Bank. *This confidence is the foundation of the establishment of dealers' houses or discount houses (or Shroffs' Houses).* Their business consists in buying bills and selling them again. This postulates that they must have money *always ready with them to buy these bills.* In normal times they are able to borrow this from banks easily. But if at a certain time the money market gets tight, the dealers fall into peculiar embarrassment ;

(a) the banks may call on them to return the money and dealers may find it difficult to sell their bills in the market to recover the money ;

(b) if business men come to sell their bills at the discount houses the dealers cannot refuse them and they would need money which they would find difficult to obtain even at a high price.

At such a period, then, they confidently sell the bills they have on their portfolio to the Reserve Bank whose doors are always open for such a transaction at the current rate of discount. They need the Reserve Bank's help not so much in normal times as in times of monetary

stringency. To repeat, the creation of Discount Houses or Shroffs' Houses depends on the institution of a Reserve Bank always willingly to purchase bills or drafts.

Similarly with the banks. If a bank is to buy bills or drafts to sell them again, it should also have the guarantee that if in times of stringency it is compelled to sell them, there is an institution which is *always* ready to buy them. This guarantee given by the Reserve Bank is the sole strength on which the bank is willing to deal in bills or drafts or is willing to give its money on loan to those who are dealing in them. A bill market cannot, therefore, exist without a Reserve Bank.

At this stage, expression may be given to another invaluable service rendered by the Reserve Bank to the money market. When it buys bills or drafts reserve money flows *into* the market and the stringency tends to be reduced. The greater the rush on the part of banks and discount houses to sell these bills at the Reserve Bank, the greater is it a proof of acute stringency. But it is just at this time that the Reserve Bank shows how it can help them by purchasing their bills. Its portfolio becomes full with bills, but when they have matured, the portfolio is emptied and money automatically returns to the Bank. And the psychological effect on the market is great. By this simple process of buying and selling bills, the market does not feel that enormous sums of money were required and were poured out of the Reserve Bank, and consequently a panic is averted. Thus a bill market enables the Reserve Bank to pour its credit into the market with smoothness and success.

Besides, in extending its credit and putting funds into the market the Reserve Bank has virtually enabled the up-country market, Kim, to reach the central money

market for funds. Thus, the Co-operative Credit Bank at Surat paid for the draft of the Society with the conviction that at least the Reserve Bank will buy it from them ; similarly the Shroffs' House paid funds to the Co-operative Credit Bank at Surat, the discount house of Bombay paid to the Shroffs' House in Surat, a Bombay Bank paid funds to the discount house and the Bombay bank itself was paid by the central reservoir, the Reserve Bank. The Society of Kim has thereby received funds from the Reserve Bank not directly but through another agency. Thus the up-country market is linked to the central money market.

A SUMMARY :—How a bill market can be established and what its advantages are, has been shown by the examples taken above. But it would not be unwise to recapitulate them. For the successful establishment of a bill market, *the fundamental essentials* are :—

(a) The creation of a bankers' acceptance or bankers' bill which shall also include those accepted by a person, a firm or a corporation engaged in doing the business of acceptance credits and recognized as such by law. As such paper possesses the essentials of *self-liquidity*, it will be readily acceptable and will have greater currency and rapidity than any other short-time paper. Besides, as it is an instrument of credit which gives to business men without finance *ready* money and *cheap* money, its adoption will be all the greater. The greater is its adoption, the stronger will the bill market tend to be.

Through the instrumentality of the Bankers' acceptance the country money market will tend to be linked to the central money market and a uniform market—'the Bill market' will be created.

(b) The second essential is a discount house (or a

Shroffs' House). It is the best intermediary to bring banks and business men in contact with one another by means of acceptance drafts. As specialists in dealing with such bills, discount houses will tend not merely to popularize them but will induce banks and other institutions to adopt acceptance business.

(c) Finally, the greatest essential is the institution of a Reserve Bank which shall be the ultimate source of selling these acceptance drafts or bills by those who want to do so. Its *guarantee to buy these bills* unconditionally will be the pivot of the bill market. And when it actually buys the bills, it will extend credit to a thirsty money market.

A BILL MARKET FOR INDIA :—But the question now is : Can these fundamentals for the establishment of a bill market be obtained in the case of India? To answer this, let the example of the Co-operative Sales' Society of Kim, just taken above, be again made use of. The greatest difficulty in India will be the creation and use of bankers' acceptances in the mofussil. In illiterate India where the producer of crops is unable to read or write, it would appear unthinkable to institute an instrument like a bankers' acceptance.

(1) *Who will be the drawer of the drafts?* But this difficulty is not insuperable. The illiterate man can be replaced by a *registered society of men* such as a Co-operative Sales' Society of which he becomes a member, which would contain at least one literate man to enable the Society to draw a draft in a standard vernacular (Hindi) on an acceptance bank or association.

But even the permanent formation of a Co-operative Sales' Society may be found difficult. Then the remedy would lie in recognizing a temporary union of the *inhabitants of a village* called, say, a Produce Sales' Society.

The minimum number may be fixed, say, to five men, giving the necessary security, (the nature of which is considered shortly) uniting to sell their produce or to store it up in a warehouse. The association may be temporary and may dissolve itself on the completion of the transaction, that is, after having paid the accepting bank in full for the draft drawn upon it. It would be prudent to begin with such temporary unions or associations to encourage their formation, because in course of time as the benefits become visible, they will pave the way towards permanency. These men have to fill in a printed form in vernacular which should contain not merely their exact identity but an account of the produce, in maunds or khandys, which they have pooled to sell in common.

(2) *Who will buy the drafts?* But the question would be, supposing such a temporary union is formed and recognized, to whom is it going to sell its draft or bill, if one is drawn on an accepting bank or association? There are various solutions for this : (1) Law may permit the existing Co-operative Central Banks to buy such paper from *any* union or association (whether formed on the co-operative plan or not) which has for its basis the financing of farm products. In this way the temporary Produce Sales' Society will have a recognized and a ready market for selling its drafts. This secured, it would not be difficult to sell the draft drawn by the Society. In the example, the Society of Kim sold the draft to the nearest buyer, the Co-operative Central Bank of Surat, which in its turn sold it to a Shroffs' House in the same town and the draft went forward on its march. The Co-operative Central Bank would serve the purpose excellently if this function of buying and selling drafts based on agricultural produce is developed.

In the United States of America there have been instituted twelve special banks called the Federal Intermediate Credit Banks which form one unit of the whole Farm Loan System. These have as an important part of their functions the discounting or purchasing of any note, draft or bills of exchange, debenture or other such obligation, the proceeds of which have been advanced or used in the first instance for *any agricultural purpose* or for the raising, breeding, fattening, and marketing of live stock ;”¹ from any bank, or trust company, or agricultural credit corporation. The extent of the help rendered by only discounting bills by these institutions will be clear from the fact that since their organization up to June, 1928 they discounted bills worth \$207,297,970.48.²

(2) But the little Sales’ Society may find difficulty in reaching a Co-operative Central Bank. In this case, then, if an *agent* of a discount house in Surat (as in the example) is stationed temporarily during the busy season at Kim, the difficulty would be eliminated. The agent would be on the spot to buy the drafts.

(3) A third alternative is also possible—the registered association of indigenous bankers recognized by the Reserve Bank in its books. Such an association would also be helpful in buying drafts, but it is questionable whether under the present circumstances these indigenous banks would be willing to associate. (This subject is again dealt with in a succeeding chapter.)

Thus the prime difficulty of giving birth to a bankers’ acceptance lies in finding *literate drawers of drafts* with the necessary security offered by them. This can be

¹ The Federal Farm Loans Act, July 17, 1916.

² Annual Report of the Secretary of the Treasury on the State of the Finances (U. S. A.) 1928. The same report also states that during the fiscal year these banks made original loans of Co-operating marketing associations of \$ 33,963,057.23.

solved, as stated above, by instituting a Co-operative Sales' Society whenever it is possible to do so ; or as an alternative, by recognizing *temporary unions or associations of villagers* (numbering 5 or more) as Produce Sales' Societies. In this latter respect, help could be given by honorary workers, or the Government revenue officers who could explain to the poor villagers the value of such associations and help them towards their formation. Propaganda is what is needed. (This subject is again dealt with more fully in a succeeding chapter.)

Then the draft to be drawn can be so improved in *form* that it contains the printed matter in both English and Vernacular. What the buyer is particular about is the *accepting bank's stamp* on it and has little to concern himself with the drawer's signature. So that, in order to give greater circulation to such drafts a form, whether drawn in English or Vernacular, would be sufficient to serve this purpose. There can be no difficulty, then, regarding the form of the draft.

(3) *The basis of Security :—Warehouses.* The next consideration is the security which the drawer would offer to the accepting bank to induce it to accept draft drawn on itself. In the case cited, the security was 100 bales of cotton in storage in a warehouse. It may be actually stored or definitely on its way to the warehouse. The existence of a *warehouse* seems urgently imperative and that too for many economic reasons : (1) In the first place, it would enable the Society of cultivators to *pool* their produce in a common place and to assign exactly the ownership of the bales of cotton amongst themselves, which would consequently make the pooling popular and give a stimulus to the growth of such Societies. And this would be an immense gain. The success of the bill

market will depend on the amount of bills or drafts which are made to circulate. But the growth of these bills depends primarily on the growth in the number of drawers who are associations or societies of the type stated above. Consequently, the larger their number, the greater will be the success of the bill market. (2) Secondly, its existence would enable the Society of cultivators to *wait* till better prices prevailed to sell their cotton, for which there would be little fear of damage by vagaries of weather or fire or plunder as in villages. And more so because once having obtained finance by selling the acceptance draft, they can afford to wait to sell the cotton within the period specified on it. To give to the Indian agriculturist this *waiting power* is to give him the best weapon to fight against indebtedness. (3) The third advantage is on the side of the acceptor. No accepting bank or Acceptance Association can ever think of lending its credit unless there is tangible security offered to it. A warehouse is the storage not merely of commodities but of security as well. It enables the accepting bank to measure the value of the security and thereby adds yet more brick and mortar to the foundation of the bill market.

THE OWNERSHIP AND CONTROL OF WAREHOUSES :—Who is to bear the burden of constructing the warehouses? In some cases, districts and local boards and municipalities might find in a warehouse not only a good long time investment but a convenient method of levying their tolls. A limited company could also be floated for the same purpose or they might be owned by the agricultural or co-operative department of the Government. Some of the banks might also construct them, and above all the Reserve Bank must at least

construct some in important centres if other agencies are not forthcoming to do so. But whoever may be the owner, the regulation of these warehouses must be under the direct control of the Reserve Bank, which shall lay down rules for their institution and management. Some warehouses may become temporarily a financial burden to the owners, but the probability is that their existence will tend to attract year after year a greater amount of storage of produce ; roads may also be developed which in course of time would make them a paying proposition.

While these bodies or institutions can own warehouses, under no conditions should probable buyers of produce, whether individuals or companies, be permitted to own them. For such ownership gives to the buyers power to prevent the sellers getting better prices for their produce. They may manoeuvre to keep out their competitors in buying the produce. The buyers can have a free hand in storing produce in their warehouses provided they have already bought produce before it was warehoused, but they cannot be allowed to store up produce belonging to the sellers, for in this case there will be room for mischief.

(4) *The establishment of the Accepting Banks or Associations* :—Another question arises regarding the institution of accepting banks or Acceptance Associations. As stated previously, no bank can afford to open a branch in a small place like Kim, which has little to boast of in business activity except transporting its seasonal agricultural produce. Nor would it pay a bank to do so, as the nature of the business is highly seasonal. In big centres some banks may open branches profitably, but in places where a comparatively large quantity of agricultural produce could be pooled without there being enough business to allow the bank to carry on throughout the year, agents

could be sent temporarily to do the acceptance business. They could open small offices in rooms let out by the warehouse authorities without entailing proportionally high expenditure on the office establishment.

But small associations formed for doing acceptance business could more successfully install themselves in these places during the seasons. They may be constituted by those who specialize in this acceptance credit business, or they may be formed by some brokers and non-brokers joined together for the purpose. Some of the Indian joint stock banks may also follow the example of the banks of the United States of America in forming what are known in that country as "Acceptance Syndicates." In these a bank acts as a syndicate manager and undertakes for an agreed commission to float an issue of acceptances for a particular customer in case the bank's ability to finance him falls short of his requirements.¹ The bank will then invite a number of other banks to participate in the Syndicate in which case each agrees to purchase or subscribe a portion of the total. Each of them receives an agreed commission for accepting drafts. The collateral that the customer should furnish is also arranged for in the contract and the syndicate manager works as trustee.

Acceptance Associations may also be formed by indigenous bankers, and these may probably prove more successful than others because they can work with profit on small commission owing to their establishment charges being a minimum. But whoever may form the Acceptance Associations, it is absolutely necessary that the Reserve Bank should have them registered on its portfolio, in which case they must be tied down by regulations regarding commission etc. Under no conditions

¹ Thomas J. Kavanaugh: *Bank Credit Methods and Practice*, Page 78.

should bargaining be allowed and the commission must be a fixed amount which is alterable only by the Reserve Bank. The control of these Associations should be left completely in the hands of the Reserve Bank, which should also fix, by inviting tenders, the number permitted to transact acceptance work in a particular place, because too many of them may not be in the interest of any.

(5) *Other essentials* :—Once the above essentials of a bill market are obtained, discount houses can be easily organized, for in our shroffs we have the ablest units in the construction of a banking edifice. On them the banks depend today for most of their business and they should be the real instruments in the construction of a bill market in India. It would be a simple process to bring together individual shroffs to form Shroffs' Houses.

II. THE MANUFACTURERS' BILLS :—So far the bill or draft created and drawn by the producer of agricultural staples and its acceptance by a bank or association has been discussed. But the same will be seen to be true in the case of a manufacturer, as the principles governing the bank acceptance remain the same. Thus take the case of a manufacturing company of cotton cloth, say, the Empress Mills of Nagpur, which enter into an agreement with a bank or an association to accept drafts drawn on it by them for a particular amount for a fixed period on the security of the quantity of cloth manufactured and stored in their godowns from time to time. Every time the godown receipt specifying the value of cloth stored is presented by the Mills to the accepting bank, a draft drawn by the Mills is returned, as was shown in previous examples, 'accepted' on its face. What the accepting bank has lent to the Empress Mills is *immediate credit* and not cash. The Empress Mills then are at liberty to

discount the accepted drafts from time to time as finance is required and this may be done at a discount house, which is presumably ready to buy the drafts from a customer of so reputed standing as the Empress Mills. Then the accepted draft is left free to pass from hand to hand, be it that of a shroff, a commercial man, or another bank—in short it will have a ready market in any part of India until it eventually reaches the accepting bank on maturity for payment. The Empress Mills, on their part, must have paid fully for the draft before its maturity to the accepting bank.

The total cost to the Empress Mills of receiving finance by this method would be made up of the *discount* they are charged for selling the draft and a small *commission* to the accepting bank for lending its credit for a fixed period. As was shown previously, in a time of monetary stringency especially, this would be, in effect, the cheapest method by which the Empress Mills could get finance and enable them to turn over their production quickly.

The succeeding diagram, like those above, explains the work of the acceptance draft in this example.

THEIR ECONOMIC VALUE :—Enough has been said to show the advantages to be derived from this system of bank acceptance by both the producer and the accepting bank, and it is needless to repeat them. But the real point to be stressed is that not only would this system of drawing acceptance drafts enable the manufacturers to obtain credit *quickly* and very *cheaply* but such a system would be an important unit in the development of a bill market in India. The larger the adoption of this system by manufacturers and banks and the greater the number of drafts made to circulate in the market, the stronger will be the bill market. Moreover this system

would be the common instrument for linking together industries, banks, commerce and all those who acquire the habit of buying and selling drafts. What is needed is a change of practice. If the cotton mills and jute mills, iron and steel works, motor works, cement works, printing presses, in fact, all large and small manufacturers were to adopt this system of bankers' acceptances much progress would be made within a few years towards a stabilized bill market in India.

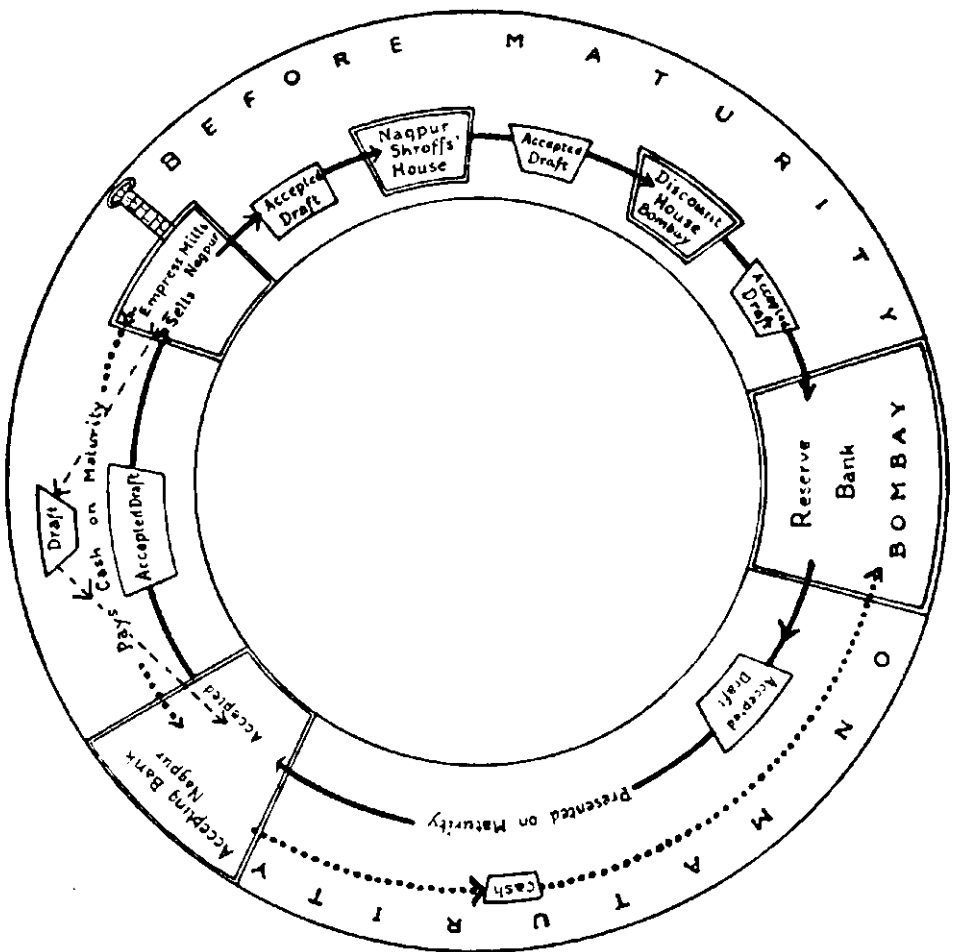


Diagram showing the working of a Manufacturer's draft accepted by a Bank.

III. MERCHANTS' BILLS :—The system of bankers' acceptances could also be quickly adopted by

merchants in India, because they can produce tangible security in goods and can draw drafts either in English or in the vernacular. Besides, they are already in close contact with banks and shroffs and can easily induce these constituents to afford them better credit facilities in the form of acceptances than those given at present by other methods.

THEIR VALUE IN FOREIGN TRADE :—But the real advantage bankers' acceptances give to merchants is in foreign trade. For example, suppose a merchant in Bombay desires to purchase a quantity of silk from Shanghai. A very long distance separates the two merchants and they do not know each other at all. Consequently, it would be extremely difficult for the Bombay merchant to induce the exporter of silk in Shanghai to do business with him. Nor could the Bombay merchant convince the Shanghai exporter of his financial position by merely sending him accounts of his business with certain banks in India, because before the shipper actually expects the payment to be made to him—which would be on receipt of the shipment by the Bombay merchant—things may have gone wrong with the Bombay merchant and his bank balance may have disappeared. Besides, the Shanghai exporter would have to wait until the silk is delivered to the importer, and this waiting brings him not merely uncertainty and risk in doing business, but as was explained previously, hampers his transactions by locking up his capital.

If, however, the Bombay merchant receives a letter of credit from his bank promising to accept drafts drawn on it by the Shanghai exporter of silk to the value laid down at a fixed period, and sends it along with his order to the Shanghai merchant, business would at once begin. The

foreign exporter may have no confidence in the Bombay merchant, but this does not matter. He *has* confidence in the accepting bank in Bombay, which bears the responsibility of making payment for his silk. The Shanghai exporter, on receipt of the letter of credit, ships the goods, sends the shipping documents with them and draws a draft on the Bombay bank which he discounts with a bank or broker in Shanghai. The Bombay merchant pays this on or before maturity of the draft to his bank which has custody of the shipping documents.

The Bombay bank has not to part with cash at once but simply lends its credit, and can therefore utilize its cash for some other business. The Bombay merchant gains because he has not to take a direct loan on the security of collateral which would have cost him much more in the form of interest. In short, the bank acceptance has divided the gain between the three parties.

Thus, commercial relations between one country and another would be created and enlarged by the use of bankers' acceptance.

DOMESTIC BILLS IN FOREIGN MARKET :-
And this connection tends to become wider and firmer when a domestic bank acceptance leaves one country to make payments to another. This will be made plain by the example taken previously of the Empress Mills of Nagpur (India).

Suppose the Mills draw a draft on the accepting bank, the Imperial Bank of India, Ltd. and that they sell the accepted draft to a discount house, which in its turn sells it to a foreign bank, the Chartered Bank of India, Australia and China, Ltd. The Bombay importer of silk in the example just taken above may buy this accepted draft from the Bank of India, Australia and

China, Ltd. and send it on to his Shanghai exporter who would deliver it to a bank in Shanghai, which works as an agent for the Imperial Bank of India and receives cash for it. Or the Shanghai exporter may sell it to Shanghai

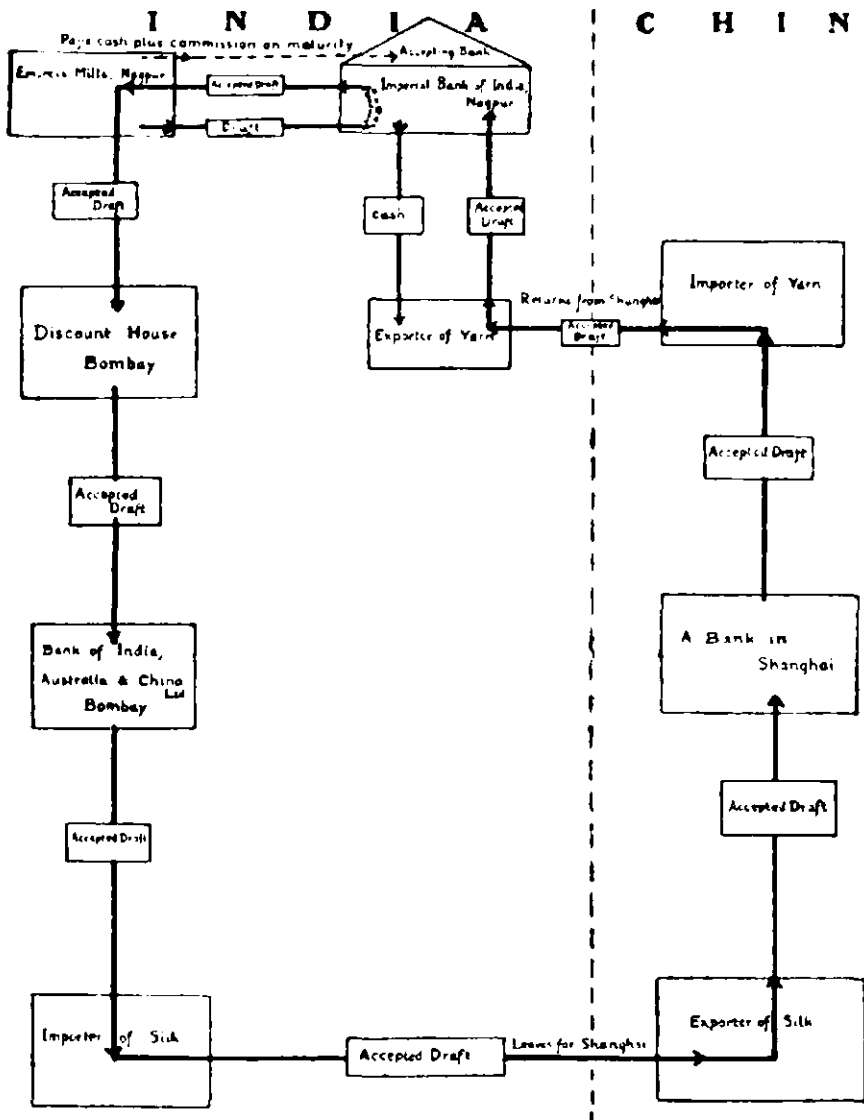


Diagram showing Internal Draft in a Foreign Market.

importer of yarn from India who transmits it to India to his Indian creditor, the exporter of yarn, who receives cash from the Imperial Bank of India on presentation of the

draft on maturity. The Empress Mills will have paid the Imperial Bank in full before maturity.

In this example, the serious difficulty of a draft drawn in *rupees* being accepted in China was not considered because concentration was laid on the economic service of the draft. But if India had for its standard a gold currency and if the Empress Mills had drawn the draft in that currency, its draft would have a freer, wider and easier market even in a foreign country. In this way India's bills would tend to be bought and sold in foreign markets and foreign bills in the Indian markets, thus giving strength and stability to the bill market in India.

A LESSON FROM ENGLAND :—In this connection, the origin of acceptances and of the discount houses in England is instructive and interesting. Some of the big merchants started the practice of paying for their imports by means of accepting drafts *drawn upon themselves*. These were discounted at different rates according to the business reputation of each merchant. In course of time, the small merchants also followed their example, but as their standing was small, their accepted drafts were discounted at much higher rates than those of the big merchants. Consequently, *the small merchants drew drafts on the big merchants* and induced them to accept them. In this way, the small merchants managed to get finance more cheaply, and the acceptance business became so profitable that the big merchants became *Acceptance Houses* instead of merchants. This evolution can be taken as a lesson to be followed by merchants in our country.

A LESSON FROM THE UNITED STATES OF AMERICA :—There was *no* Bankers' Acceptance in the United States of America before the Federal Reserve System was established in 1913. The Act instituting the

Federal Reserve System empowered the banks in America to accept drafts drawn upon them and permitted the Reserve Banks to purchase them. This gave birth to bankers' acceptance, which was taken over from Europe. The Americans took it up so readily that the bill market for acceptance is at present even larger than the market for commercial paper. Mr. Burgess gives an idea of its growth.¹ The commercial paper market which, as he states, had more than fifty years of existence, accounted for about \$ 577,000,000 of paper outstanding as compared with about \$ 750,000,000 of bankers' acceptances outstanding at the end of December 1926. What tremendous strides the bill market has made can be deduced from the fact that whereas before 1913 there were no bankers' acceptances, the bills purchased *outright* by the Reserve Banks alone during 1926 were valued at the bewildering figure \$ 1694 millions. More than one-third of these bills were drawn to finance the movement or storage of American farm products; those drawn for financing cotton alone were valued at \$ 368 millions; sugar shared \$ 209 millions; coffee shared \$ 138 millions; silk shared \$ 123 millions and grains shared \$ 97 millions. Add to these the bills bought and sold by the 30,000 and more banks of the country, and a bewildering figure would be reached. Equally instructive is it to know how popular the bill is with the people of America. An inquiry was made some time ago, writes Mr. Burgess, by the New York Reserve Bank to ascertain who the buyers of acceptances were in 1926. Apart from banks, savings banks, insurance companies, discount houses, business men, manufacturing concerns and a host of others, there have been institutions such as publishing houses, a hospital

¹ The Reserve Banks and the Money Market, Pages 126-149.

in Connecticut, an athletic club in Maryland, trustees of Protestant churches, bishops of Roman Catholic dioceses, colleges large and small and hundreds of other organizations scattered over the country.

CONCLUSIONS :—Bankers' Acceptances or bills can be introduced in India with success in order to establish a bill market for the country. In the case of some constituents, such as agricultural producers, it would take some time before bankers' acceptance is appreciably developed owing to widespread illiteracy and old habits in the villages. *But a successful beginning can be made, if as suggested previously, temporary associations or unions of villagers as Produce Sales' Societies or Co-operative Sales' Societies are organized for the purpose.* Bankers' Acceptances will quickly win the favour of the villagers, for they are easy to understand and will enable them to receive cash *before* their produce is sold. They will enable the agriculturist *to obtain the finance* he needs for moving or storing his produce and that too in the *cheapest way* possible. And as explained above, they would be instrumental in *connecting the up-country money market* with the central city money market.

BANKERS' ACCEPTANCE IS SUPERIOR TO CASH CREDIT :—Bankers' acceptances could be easily taken up as a system of finance by manufacturers and business men. What is needed is a modification of the time-honoured system of receiving over-drafts and cash credits, since these are more difficult and dearer methods of receiving finance than bankers' acceptance, particularly in times of monetary stringency.¹ A cash credit is an

¹ Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, said before the Royal Commission: "If the development of Banking in India takes the form of an overdraft account which

advance by a bank to an individual of such sums of money as he may require from time to time, not exceeding in the whole a certain *definite* amount. But the individual receiving a cash credit has to enter into a bond to furnish *at least two securities* for the repayment on demand of sums actually advanced, with interest upon each issue from the day upon which it is made.¹ And these *securities may be difficult to find and the advance limited in amount*. Besides, although the party receiving a cash credit has the advantage of paying interest only for the money he actually employs, he pays a *higher rate of interest* on a cash credit than on a bill. Banks charge higher interest upon cash credit than upon bills because they have to part with actual money immediately and for a particular period, and once a credit is granted it is not usually suddenly called up.

BANKS SHOULD CHANGE THEIR METHODS:—Banks, too, have to change their methods. They should be willing to become accepting banks and welcome acceptance credit, as it is the safest form of lending credit. As explained above, a bankers' acceptance is the best self-liquidating paper. It would earn for them a lower rate of interest than over-drafts, but as the volume of acceptance business increases with growth of its knowledge and popularity, the profits on the whole would remunerate them sufficiently. It would enable the banks to increase their loaning capacity manyfold. Accepting banks should also be supplemented by small Acceptance

produces no negotiable instrument which can be taken to a Bank of issue, certainly it will retard the functioning of the bank of issue, which requires for its conduct that borrowing be on the best type of paper that the commercial banks get from their customers." Answer to (Q.) 15,416.

¹ J. W. Gilbert: The History, Principles and Practice of Banking, Vol. I, Page 187.

Associations in places where it is difficult to establish bank branches in the country.

Finally, a supreme organizing agency is needed to bring into existence and to support a bill market in India. Its *guarantee to buy unconditionally bankers' acceptances* will enable it to offer its financial help to the money market when needed and will be the real foundation on which the bill market edifice will stand. ¹

¹ The *Hundi* as an asset in the formation of the Bill Market is discussed in Chapter XIV.

CHAPTER XIII

THE RESERVE BANK OF INDIA AND AGRICULTURAL FINANCE

AGRICULTURAL INDEBTEDNESS:—There is probably no other country in the world where the usurious money-lender thrives so well as in India. For generations the cultivator has had to struggle ceaselessly to extort a bare subsistence from insufficient holdings and has been a victim to disaster from drought, flood or epidemic. "To a very great extent," wrote the Royal Commissioners "the cultivator in India labours not for profits nor for a net return, but for subsistence. The crowding of the people on the land, the lack of alternative means of securing a living, the difficulty of finding any avenue of escape and the early age at which a man is burdened with dependents, combine to force the cultivator to grow food *wherever he can and on whatever terms he can*. When his land has passed into the hands of his creditor, no legislation will serve his need; no tenancy law will protect him, for food he needs land and for land he must plead before a creditor to whom he probably owes more than the total value of the whole of his assets."¹ When his very existence is at stake there is indeed no recourse but to borrowing, even if the Shylock demands 'a pound of flesh' in return.

Throughout these generations of misery the cultivator has remained illiterate. With illiteracy and ignorance, thrift is absent. Buried in social customs, almost in super-

¹ Report of the Royal Commission on Agriculture in India, Page 433.

stitutions, the cultivator borrows money recklessly for unproductive purposes, and it is to the interest of the money-lender or the *Sahukar* not merely to loan money most recklessly but to encourage and spread these superstitions under the garb of religious tenets. There have been so far no accurate statistical data to give any idea of the extent of the unproductive debt of the cultivators, but there is no doubt that it must be considerable. Money-lenders are usurious and the ready lending for unproductive purposes leads to poverty and economic servitude.

Besides, it is the load of hereditary debt which has made the cultivator utterly helpless. "The crushing burden of hereditary debt," wrote the Royal Commissioners, "remains largely through ignorance of the legal position which is that no personal liability is transmitted and that no suit lies against the heirs of a deceased debtor except to the extent to which the property of the deceased has come into their hands by survivorship or succession."¹ The people are so accustomed to be in debt, to inherit it from their fathers and to pass it on to their sons, that they accept indebtedness as a natural state of life. "The inevitability of indebtedness, as it seems to the people, gives the money-lender enormous power. It produces an almost fatalistic acceptance of the steady transfer of land into his possession and leaves his paramount position unchallenged."

To this must be added the force of tradition that the son or relative regards the debt as a debt of honour. Once having affixed his thumb-mark on the bond or promissory note, he feels obliged to pay and "even if the matter is taken to a civil court, will rather admit receipt of a consideration which was never received than run the

¹ Report of the Royal Commission on Agriculture in India, Page 435.

risk of being thought to dishonour his father or relative.”¹

While such has been the fate of the poor cultivator, the *Sahukar* has steadily grown stronger both in money with his accumulated profits of years and in stabilizing his hold on the debtor's lands. The establishment of law courts and the enactment of various measures like the Contract Act have also enabled him to strengthen his position. The development of commerce and trade and of credit has given him greater scope for the investment of his profits and thereby tended to make him stronger. The *Sahukar* is not merely the usurious money-lender but is a buyer and seller of agricultural produce as well. In most cases he lends money not merely at usurious rates but on condition that the cultivator sells the produce to him at a stipulated price. In such cases a loan of money also takes the form of a loan of seeds, manure, cloth, bullocks and so on. The cultivator, thereby, stands to lose in two ways. Not only is he compelled to pay usurious interest but he is forced to sell his entire produce at a price which presumably is much lower than the market price. In many cases the *Sahukar* often gets from the cultivator-debtors small gifts in cash or kind at Diwali or some auspicious occasions.² Then again, the borrowers are required to give an undertaking to sell their produce through him and he charges *Dalali*, or commission on sale.

In view of the cultivator's illiteracy and chronic indebtedness, any conclusion may be drawn as regards the rates of interest charged by the *Sahukar* and the condi-

¹ Report of the Royal Commission on Agriculture in India, Page 440.

² Indian Central Cotton Committee's General Report on eight investigations: Page 18.

tions under which he makes an agreement for a loan. The rates are numerous and vary generally from 12 per cent. to 75 per cent. (and in hundreds of cases up to 150 per cent. and more). The nominal rates charged may be less than these figures but if the various conditions enforced on the poor cultivator are considered the real rates would be much higher. Even during the off-season the rates are very high, for the borrowers are accustomed to pay them. Besides, the rates of interest are calculated according to various systems some of which are applied by the *Sahukar* simply to prey on the ignorance of the cultivator.¹ In many cases advances are made to cultivators on the security of jewels which are pledged with the *Sahukar*, or mortgage of land, livestock or crop. But generally for ordinary loans no security is tendered and the thumb-mark of the borrower in the *Khata-book* (account-book) of the *Sahukar* or on the bond or promissory note is quite sufficient.

Time and again Government has intervened to give relief to the indebted cultivators by legislation. But legislative measures 'have proved a comparative failure.' The Usurious Loans Act of 1910 is practically "a dead letter" in every province in India and "if the provisions of that Act were fully utilized, this would go far to remove the worst evils of uncontrolled usury."² The Provincial Governments of Bombay and Punjab have also passed Acts to give relief to the agriculturists, but the *Sahukar*

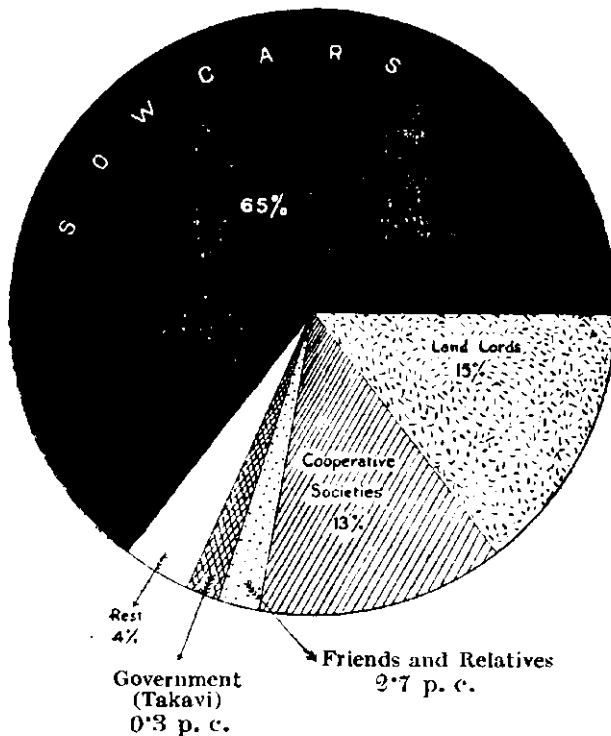
¹ In the General Report of the Indian Central Cotton Committee (on Eight Investigations into the Finance and Marketing of cultivators' cotton, Page 117) three commonest systems are stated: (1) The *anna* system, e.g. one half-anna per rupee per mensem (=37½ per cent.), (2) The ordinary system, e.g., one per cent. per mensem (=12 per cent.), and (3) what is called *Panjoth* in Sind, and *Sawai* in Khandesh and Berar. Both words mean 25 per cent.; but as loans are made for about 6 months the interest really works out to 50 per cent.

² Report of the Royal Commission on Agriculture in India, Page 435.

is still uncontrolled in his dealings. Stricter enforcement of legislation may indeed control the *Sahukar* in his usurious dealings, but the real salvation of the agriculturists is to be found in the cumulative effects of a healthy and well-organized co-operative movement and the spread of literacy.

SOURCES OF ADVANCES:—The extent to which the *Sahukar* finances the cultivator varies in different parts of the country, but his share in financing is the largest. There are no statistical data to give an accurate idea of the hold the *Sahukar* has over the cultivators in

Sources of Advances.



Percentages of amounts borrowed by cultivators from various sources in India.

India, but the close investigations made by the Indian Central Cotton Committee in the eight important cotton tracts in India reveal the true position of the sources of

finance of the cultivators.¹ The preceding diagram shows the percentages of the amounts borrowed by the cultivators from various sources.

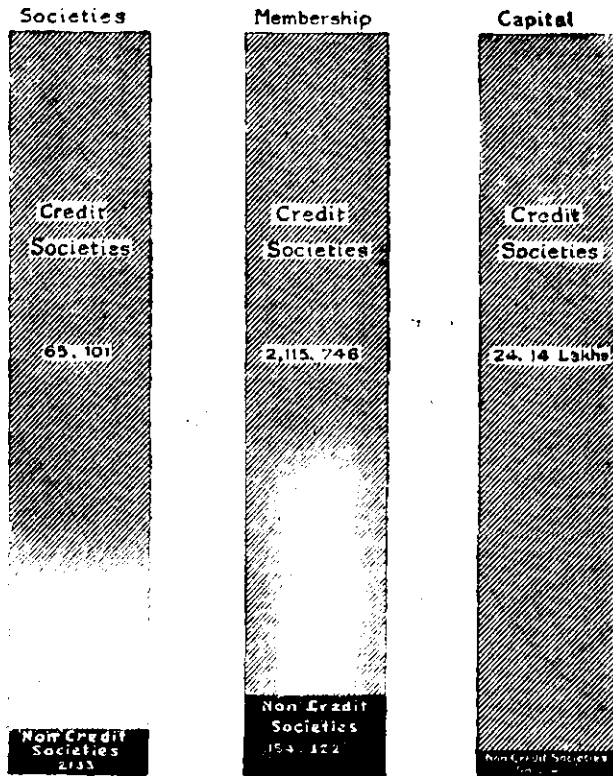
The diagram shows that the most important source of the cultivators' finance is the *Sahukar* and after him is the landlord. Although the part played by Co-operative Societies in financing is only 13 per cent. of the total, they have succeeded in modifying the rate of interest charged by the *Sahukar*. The Report of the Committee also states that in the area investigated, nearly 70 per cent. of the cultivators were borrowers.

THE RURAL CO-OPERATIVE MOVEMENT:—For the purposes of this chapter, it is not necessary to describe the rural co-operative movement in India in detail. But its principal characteristics may be stated. The foundation of the movement was laid in 1904 with the passing of the Co-operative Credit Societies Act in that year. The Act was not the result of any general demand on the part of the people of the country but of a conscious effort on the part of the Government anxious to introduce a systematic movement for the economic uplift of the Indian masses. The movement has developed mainly through the efforts of the official staff. At the beginning the movement had necessarily to be a period of experimentation—a period of trial and error—the Act was restricted to *credit* only, but in course of a few years the movement became so popular that even non-credit institutions were started in some of the Provinces and in 1912 another Act had to be passed giving recognition to non-credit societies also. This Act has been the mainstay of the co-operative movement in the country except in Bombay and Burma, where it has been

¹ General Report : Pages 8-14.

replaced by local legislation to suit special requirements.

But in spite of co-operative non-credit societies spreading in various forms over the country, co-operative societies for *credit* almost completely outweigh the former, as shown in the following diagram.



Agricultural Co-operative Societies in India in 1926-27.

REASONS FOR CREDIT PREPONDERANCE:—The preponderance of the credit element in co-operation is due chiefly to the fact that the most crushing burden on the agriculturists is indebtedness. The Royal Commission on Agriculture in India expressed the reason for this credit preponderance in the country thus : “where they are so bound to the money-lender that all their produce should be sold to him and all their purchases

made from him, where the interest charges on the loans they take from him are such that they absorb what little surplus there may be and the enhanced return in a bumper year or from some improvement in seed or implements merely serves to stay the pace at which these charges mount up, it is hopeless to expect that they should lend a willing ear to the advice of the agricultural expert. Societies for purchase or sale are not for those whose every transaction must pass through the single channel of the village money-lender.”¹ The co-operative movement must, therefore, continue to be directed towards the expansion of credit societies until the crushing burden of debt on agriculturists is considerably reduced.

Another reason for credit preponderance lies in the ‘educative value of the good credit society.’ It is a training school which teaches concretely the economic methods of using credit, of spending money, of accumulating savings however small and the value of forming organizations for mutual help. This element accounts for its popularity and success.

THE STRUCTURE OF CO-OPERATIVE CREDIT ORGANIZATION :—The typical structure of the organization of rural Co-operative Credit in India may summarily be stated to consist of :—

- (1) The Primary Co-operative Credit Societies.
- (2) The Co-operative Unions and Institutes.
- (3) The Co-operative Central Banks.
- (4) The Provincial Co-operative Bank.

(1) *The Primary Co-operative Credit Societies* :—The basis of the movement is the Primary Credit Society. It is based on the *Raiffeisen System*. Villagers living within a small area form a society for borrowing money on their

¹ Report of the Royal Commission on Agriculture in India, Page 445.

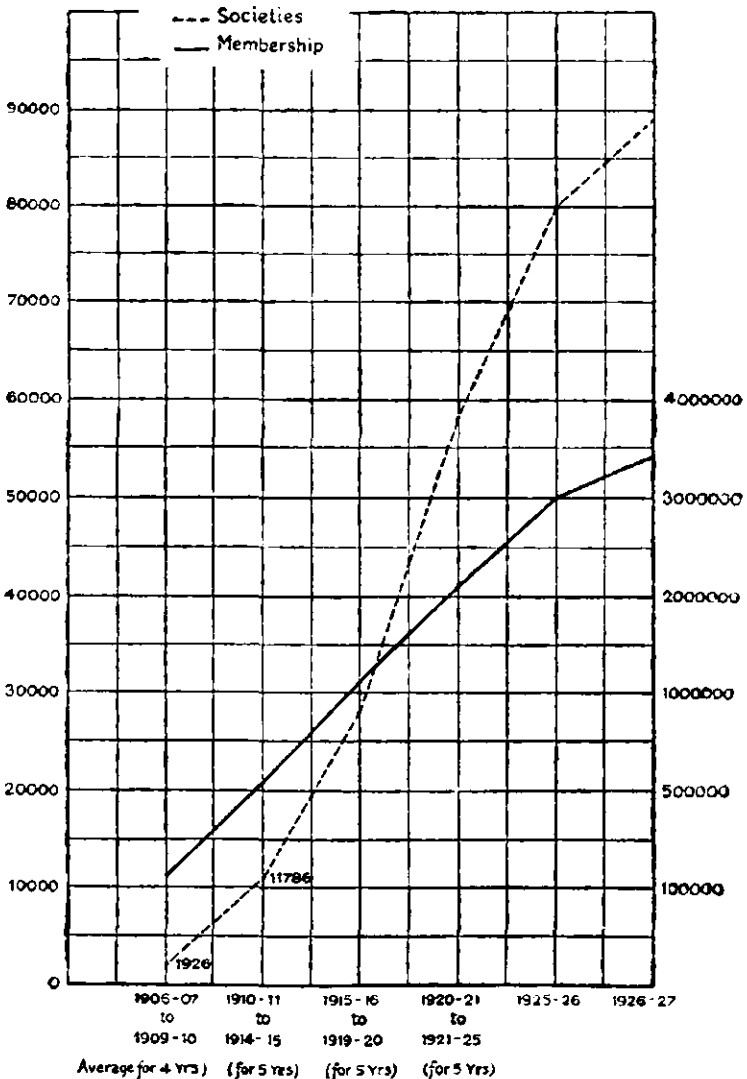
joint responsibility for agricultural operations. The minimum number necessary to form a Society varies with the Provinces. The area of the operation of a Society is *small* because, as the responsibility is individual and collective, it is essential that each member must know another's liability well. Besides, management, supervision and repayment of loans are facilitated.

Generally the societies are started with an initial entrance fee, but unlike the Raiffeisen System, it was found necessary to institute share capital in some provinces, and with it the distribution of dividends has also to be permitted under certain restrictions. But the liability is generally *unlimited* and has proved successful in creating a spirit of solidarity and discipline among the villagers with whom it has become popular. Unlike the Raiffeisen System which insisted on perfect security for giving a loan, the security accepted from the individual borrower is *personal*. From the inception of the movement up to to-day the personal security of the borrower has been the outstanding basis for loans.

The period and the maximum amount of the advances vary in different cases. But the loans, unlike those of the Raiffeisen System, are given for unproductive purposes also under restrictions, because in India religious and social customs are so binding on the villager that he is forced to borrow for ceremonial expenditure, and unless money is lent to him for this purpose, it would be impossible to save him from the money-lender. The time of repayment of the loan is usually after the harvest.

The Reserve Fund is indistributable, but, in times of stress and in case of bad debts, the members can fall back upon it with the permission of the official controller of the co-operative movement of the Province, the Registrar.

The larger the Reserve Fund becomes the greater is the credit of the Society, and borrowing becomes cheaper. Besides, common ownership of the Fund binds the co-operators together and attracts more members and more deposits. The following diagram shows the very encouraging growth in the number of societies and membership in India.



Growth in number of Co-operative Societies and their membership for all India since 1906-07.

The working capital of the societies is obtained from various sources, such as deposits from members and non-members, but the bulk of it in all provinces is obtained by loans from co-operative banks and other co-operative societies.

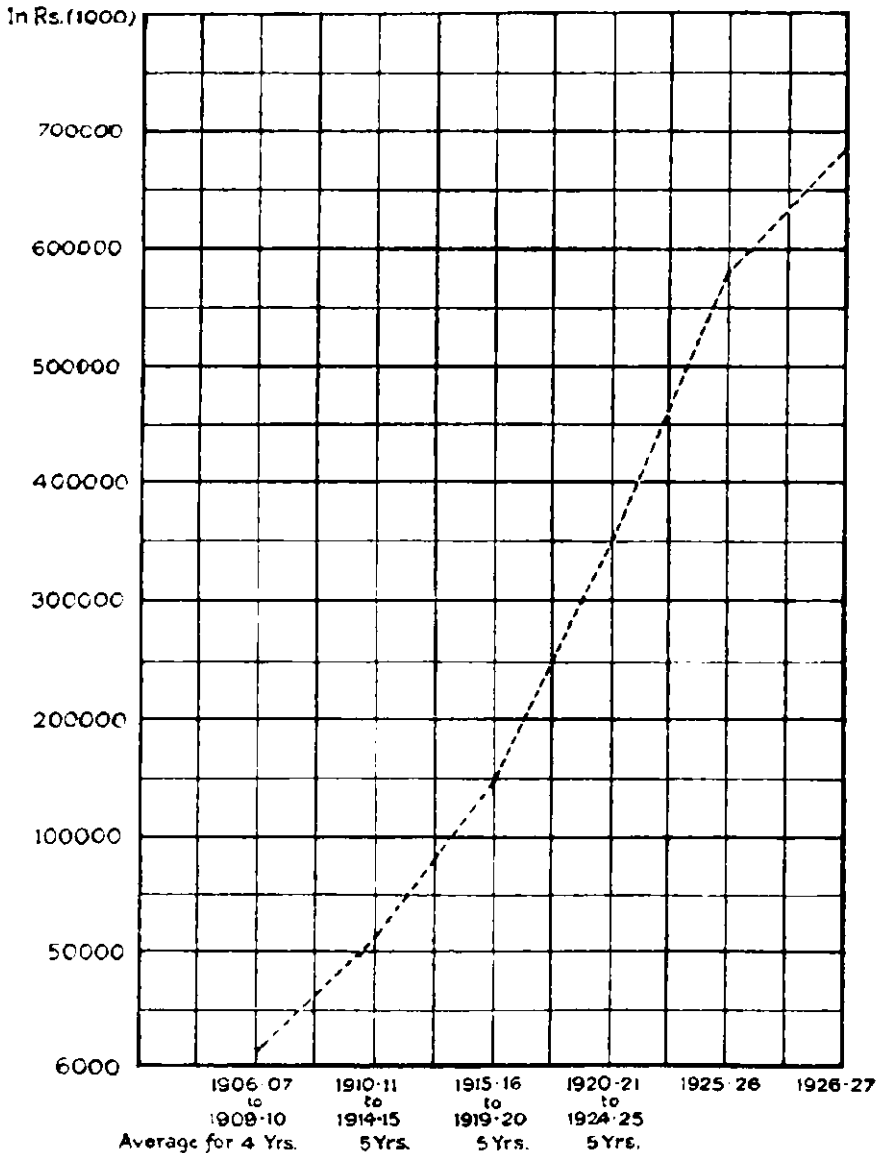
Their administrative system is very simple and democratic. Members of the Society elect their own managing committee and one man has one vote. Generally all offices are without compensation.

(2) *Co-operative Unions and Institutes*:—The co-operative unions have been formed in many provinces to federate societies into unions for purposes of supervision and guidance. Such unions take no financial responsibility but help societies with advice and develop the co-operative movement within their areas. There are also established Provincial Federations which are known in some instances as Co-operative Institutes, which have for their object the promotion of the co-operative movement in all possible ways by serving as a centre of co-operative activity, by carrying on propaganda and publicity work and by developing diverse types of Societies.

(3) *Co-operative Central Banks*:—To finance the Societies, Central Co-operative Banks were started in each Province. Their functions are to balance the funds of societies and to supply capital. Often they do the work of supervision and organization of Societies also. Generally, the unit of area fixed for a Central Bank is the revenue district. The constitution of Central Banks varies. They may be classified under three general heads:—(1) those whose membership is confined to individuals or where Co-operative Societies are admitted, both are on equal terms; (2) those whose membership is confined to Societies only and (3) where individuals and Co-operative

Societies both exist as members but the latter have special representation on the Board of Directors. There are at present nearly 560 banks of this type in this country.

(4) *The Provincial Co-operative Banks* :—At the top stands the Provincial Co-operative Bank as the apex bank



Working Capital of Co-operative Banks for all India, showing the increase since 1906-07.

in nearly eight provinces in India. Such banks are generally constituted with Co-operative Central Banks as

shareholders and work as bankers' banks for them. They co-ordinate the financing by Co-operative Central Banks and are the chief advisory and supervising authority.

The magnitude of the financial help given by the eight Provincial Co-operative Banks and nearly 560 Co-operative Central Banks can be deduced from the fact that out of the total working capital for all India of nearly Rs. 68 crores, the amount of deposits and loans held from the banks alone was nearly Rs. 23 crores in 1926-27. The tremendous growth in working capital for all India will be evident from the preceding diagram.

RELATION OF IMPERIAL BANK TO CO-OPERATIVE BANKING:—The Imperial Bank of India extends its financial facilities to co-operative banking by discounting the promissory notes of the societies or banks. The banks to which advances are made are required "to give an undertaking that all promissory notes held by the Imperial Bank as security are covered by actual advances made to Societies or Central Banks."¹ There are besides various other conditions under which advances are made by the Imperial Bank. For instance, before granting advances, it is necessary that the balances of the Central Banks concerned should be submitted for scrutiny, and advances are for crops and purely seasonal and do not exceed a period of six months. The Imperial Bank keeps a margin of 20 per cent. on actual advances made by the Provincial Co-operative Banks to Societies or Central Banks. They also receive the facility of remittance transfer at par without commission up to prescribed limits from the Imperial Bank.

The following table gives evidence of the credit facilities given by the Imperial Bank to co-operative banking.

¹ Mr. A. L. F. Brayne: Memorandum on relations between Co-operative Banking and the proposed Reserve Bank of India.

Advances to Co-operative Banks,¹ June 1927.

| Limit of Credit | | |
|---|---|-------------------|
| Against Government and other authorised securities etc. | Against borrowers' D. P. Notes and those of Societies | T O T A L |
| Rs. 134,36,200 | Rs. 1,02,52,000 | Rs. 236,88,200 |

EFFECT ON POPULATION:—The extent to which the rural population in the *major* provinces has been touched by the co-operative movement is shown in the following table.²

| Province | Proportion of members of Agricultural Societies to families in rural areas | |
|-------------------|--|------------------|
| | All Societies | Credit Societies |
| | Per cent. | Per cent. |
| Bombay | 10 | 8·7 |
| Punjab | 10·9 | 10·2 |
| Bengal | 4·4 | 3·8 |
| Madras | 8·3 | 7·9 |
| United Provinces. | 1·8 | 1·8 |

SHORT-TERM AND LONG-TERM CREDIT :—

The statistical development of rural co-operation given above shows what remarkable progress it has achieved during the last twenty-six years. But practically nothing has so far been attempted in the direction of long-term credit which has for security land mortgage business. Primary Co-operative Societies cannot undertake land mortgage business as it is entirely outside their field of

¹ This table is taken from Mr. A. L. F. Brayne's Memorandum on Relations between Co-operative Banking and the proposed Reserve Bank of India, submitted to Government in 1927.

² Deduced from the Report of the Royal Commission: Page 447.

operations. The Primary Society, which relies for its funds on short-term loans or deposits which are withdrawable at short notice, cannot afford to lock up its little capital in land-mortgage for a long time or plunge itself into the legal intricacies that accompany land mortgage. Besides, as the basis of its credit is the personal honesty and the unlimited liability of the members, it should confine itself to short-term loans repayable from the income derived from agriculture. It is the proper function of mortgage banking, which has for its security landed property, to deal with long-term loans repayable out of savings over a term of years and needed for permanent investments of land or for the liquidation of past debts. It follows that "a Mortgage Bank and a Rural Primary Co-operative Society are therefore complementary. The respective spheres of their legitimate operations are distinct and should not overlap."¹ For short-term loans personal security is good enough, but it is not so for long-term loans, which must rely on land mortgage as security. But to refuse a member of the Society a long-term loan which he can claim with his landed property as security, is to drive him to the usurious money-lender. In India, the Co-operative Acts provide for land mortgage credit and in the Punjab there are already a dozen land mortgage banks on the Co-operative plan, a typical one being the Jhang Co-operative Land Mortgage Bank. In Madras there are nearly fifteen petty banks of this type.

PAST DEBT OF THE AGRICULTURISTS :—

The necessity for the institution of mortgage banking becomes self-evident, particularly when regard is paid to the fact that the *accumulated past debt of the Indian Agriculturists is estimated at nearly Rs. 800 crores*. Assum-

¹ Report of the Ceylon State Mortgage Bank Committee, Para 4.

ing that on the average the agriculturists are made to pay only 15 per cent. on this sum, they must produce annually crops of the value of nearly Rs. 120 crores to pay for the *interest alone*. A part at least of this payment for interest must form a part of the present short-term loan demanded by the agriculturists. But if, after a short-term loan has been taken, the rains fail, it will pass into the category of a long-term loan. The Primary Societies are designed to finance the small cultivator for short-terms. They are not intended to meet the needs of the large landed proprietors and "it is the large landed proprietor of India who forms the money-lender's easiest and readiest prey."¹ It is the large landed proprietor who needs large sums of money for long terms for land improvements and for redemption of old mortgages. Figures of past debts show what an enormous field exists in India for the service of Land Mortgage Banks. The principal objects of such banks should be, as stated by the Conference of Registrars held in Bombay in January 1926, as follows :—

- (a) "the redemption of the land and houses of agriculturists ;
- (b) the improvement of land and of methods of cultivation and the building of houses of agriculturists ;
- (c) the liquidation of old debts, and
- (d) the purchases of land in special cases to be prescribed by the by-laws."

The organization of such banks is dealt with in subsequent part of this chapter.

Considering the supreme importance of agriculture to the national economy of India it is natural to expect that unless a Reserve Bank has for its principal service the

¹ Report of the Royal Commission of Agriculture in India, Page 461.

financing of agriculture it will not be an institution worthy of the name. Its constitution should be so framed that agriculture will be well looked after.

TYPICAL CONSTITUTION OF THE COMMONWEALTH BANK OF AUSTRALIA. A Rural Credits Department:—In this respect, the Commonwealth Bank of Australia has set an example to the Central Banks of the world. The Commonwealth Bank (Rural Credits) Act 1925 established in September of that year a special department of the Bank for rural credits. The principal object of the Act was “to provide facilities for the orderly marketing of Australian Primary Produce.”¹ The Rural Credits Department of the Bank is by the Act kept *distinct* from all other departments of the Bank.

Financial assistance from the Government:—Without entering into details, a few facts may be mentioned regarding the financial help which the Rural Credits Department obtains from the Government for financing agriculture. These sources are as follows:—

(i) ‘The Treasurer may, from time to time, out of moneys legally available, lend to the Rural Credits Department such sums, for such periods, at such rates of interest as are agreed upon by the Treasurer and the Bank, provided that the total sum so lent and not repaid shall not at any time exceed *Three Million Pounds*.’

(ii) Besides, “*Twenty-five per centum of the net annual profits of the Note Issue Department shall be paid into the Rural Credits Department until the amount so paid reaches a total of Two Million Pounds.*”

¹ Letter of the Secretary, Commonwealth Bank of Australia to the Writer; 22nd September, 1929. By the Act ‘Primary produce’ means “Wool, grain, butter, cheese, fresh preserved or dried fruits, hops, cotton, sugar and such other produce as is prescribed”: Act Part VI-B (60 A. B. A.).

(iii) In addition, for the same purposes 'the Bank may issue *debentures* the amount of which shall not at any time exceed :—

- (a) the amount advanced on primary produce by the Rural Credits Department and still outstanding as at the date of issue of the debentures ; or
- (b) four times the amount of the aggregate of the amount paid (1) the sums lent by the Treasurer and not repaid, (2) moneys paid out of the net profits of the Note Issue Department and (3) the money at credit of the Reserve Fund of the Rural Credits Department whichever is the greater.

(iv) Over and above these, the Bank may make advances to the Rural Credits Department of such amounts and subject to such terms and conditions, as the Board determines.'

Advances and Bills discounting by the Rural Credits Department :—The Rural Credits Department is permitted to make advances, upon the security of primary produce placed under the legal control of the Bank¹ to :—

- (a) the Bank or other banks ;
- (b) Co-operative associations recognized by law ; and
- (c) such corporations or un-incorporate bodies recognized by law and specified by proclamation.

The period of advance is limited to *one year*. Thus the Rural Credits Department is established for *short-term credit*. In lieu of making advances, the Rural Credits Department may on behalf of the institutions stated above

¹ In addition to the commodities stated above, by Statutory Rules, 1928 No. 78 the following were included, wine, spirit, meat, eggs, egg-pulp, precious and other metals, broom millet, arrow-root flour, superphosphate and Pea-nuts.

(a), (b) and (c), discount bills secured *upon produce* placed under the legal control of the Bank.

Profits of the Department :—The net profits of the Department shall be dealt with as follows :—

- (a) One-half shall form the “Rural Credits Department Reserve Fund” and
- (b) One-half shall form the Rural Credits *Development* Fund, to be used in such manner as the Board directs for the promotion of primary produce.

Extent of financial facilities to Agriculture :—The extent to which financial help has been rendered to agriculture by the Rural Credits Department is shown by the following figures which are given in the Directors’ Report.¹

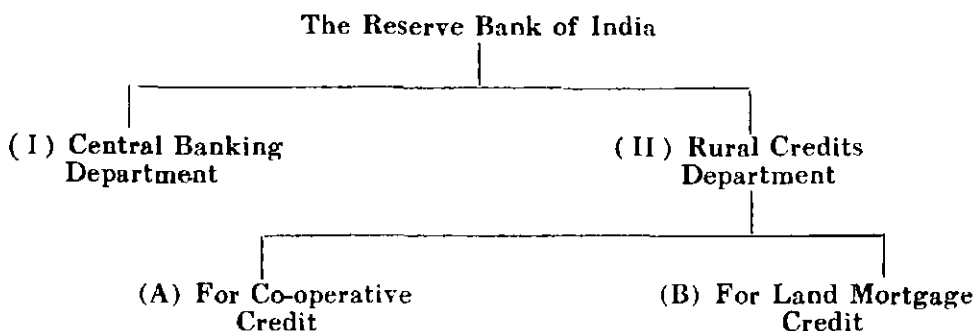
| Year ending June | Finance offered to agriculture |
|------------------|--------------------------------|
| 1926 | £ 7,427,649 |
| 1927 | ,, 5,860,162 |
| 1928 | ,, 8,445,362 |

The rate of interest charged in connection with the advances under this Department was maintained at 5½ per cent. Even some Trading Banks availed themselves of the opportunity to share the business at this rate. These figures are a convincing proof of the very substantial help given by the Department to agriculture.

THE CONSTITUTION FOR THE RESERVE BANK OF INDIA :—In order to enable the Reserve Bank of India to give its best services to agriculture, the

¹ The Report accompanies the Thirty-fourth Balance Sheet of the Commonwealth Bank of Australia, as at 30th June, 1929.

example of Australia must be followed. But there should not merely be a special '*Rural Credits Department*' of the Bank, but this Department itself may be subdivided into one for co-operative credit and the other for Land Mortgage Credit. This may be shown as follows :—



But how are these sub-departments of the Rural Credits Department to be related to the general co-operative organization which at present exists in the various Provinces in India, and to the newly proposed land mortgage credit organization?

RELATION OF THE RESERVE BANK WITH THE CO-OPERATIVE ORGANIZATION :—The Rural Credits Department for Co-operative Credit may be managed by a *committee* of 3 members, composed of (1) an experienced Registrar of Co-operative Societies to be nominated by the Governor-General-in-Council, (2) a Director of the Reserve Bank to be nominated by the Board of the Bank and (3) a representative of the Indian Provincial Co-operative Banks' Association to be elected by it.

But this committee has to be responsible to the Board of Directors of the Reserve Bank.

The Rural Credits Department would serve as an *apex institution* for co-ordinating the various parts of the Co-operative organization. It would serve "the neces-

sity of either an Imperial Board of Co-operation" as suggested by the External Capital Committee, "to co-ordinate the working of the movement and to facilitate the supply of funds from *plus* Provincial Banks to *minus* Provincial Banks or the organization of a strong central institution for the finance of the whole movement in India by the amalgamation of the existing Provincial Banks".¹

Indeed, apex co-operative institutions exist in many countries, such as, the Central Bank of Co-operative Societies of Japan, Banque Des Co-operatives De France, Deutsche Raiffeisen Bank in Germany, the National Co-operative Credit Institute, Rome. Such Institutions are either aided by the State or are given some form of guarantee in the form of debentures etc. But since in India the Reserve Bank is expected to give its credit facilities to the co-operative units through the Provincial Co-operative Banks, which are the mainstay of co-operative finance and serve as bankers' banks for the Co-operative Central Banks, it would be a better plan to co-ordinate the activities of the various co-operative units in the special Rural Credits Department of the Reserve Bank. More intimate relation of the Co-operative Banks with the Reserve Bank is also essential for the reason that, as suggested previously,² the Co-operative Banks are also to embark upon the business of dealing in Bankers' Acceptances which are to form the basis for a bill market in India. Why separate the co-operative organization by the creation of an apex institution from the Reserve Bank? On the contrary, the chain of finance

¹ Report of the External Capital Committee: Page 57. Mr. M. R. Darling in his work 'Co-operation in Germany, Italy and Ireland' suggests a Co-operative Apex Bank for the whole of India, linked under Government Control to the Imperial Bank.

² See Chapter XII.

to give facilities to agriculture would be complete when the Reserve Bank forms the first and the strongest link in it, thus :—Reserve Bank—Provincial Co-operative Banks—Co-operative Central Banks—Co-operative Credit Societies. The same chain would be very useful for discounting bills and other papers. On the one hand, the Reserve Bank will be the pioneer in giving financial assistance to the Co-operative units, and on the other, these units will be the real auxiliaries in the formation of a bill market for the Bank. The Reserve Bank should, therefore, take the co-operative units as its adopted children.

During the debate on the Reserve Bank Bill, Sir Basil Blackett, the late Finance Member, said, "The Reserve Bank, I think, ought certainly to be an extremely useful institution for the purposes of the Provincial Co-operative Banks but I think it would be a more useful institution than a single Co-operative Bank for the whole of India. I do not think that the Co-operative Banks should come under the same category as joint stock banks and be asked to place with the Reserve Bank as a matter of legal obligation a proportion of their time and demand liabilities. But that the Reserve Bank should through the Co-operative banks use its influence for the advancement of the financial interests of agriculture and the agriculturist is, I think, most desirable and I hope when it comes into existence it will do a great deal to advance the interests, through the co-operative banks, of agriculture, of the marketing of produce and of the facilities for agricultural loans generally."¹ The constitution suggested above will place the Reserve Bank in a position which would enable it to fulfil the hopes of the late Finance Member.

¹ Speech in the Legislative Assembly, 10th February, 1927.

FINANCIAL HELP THROUGH THE RURAL CREDITS DEPARTMENT :—Granting the fact that the Rural Credits Department of the Reserve Bank is established, the financial help which it is to provide to the co-operative organization should be considered. This help is to emanate in various forms.

In the first place, in order to develop *branch banking* in India, it was proposed in Chapter X, that the share of the co-operative banks in the amount to be loaned free of interest from the balances of the Government for five years as an experiment was to be Rs. 2 crores annually. This amount would be distributed by the Rural Credits Department among the various Provincial Co-operative Banks in proportion to the number of societies existing within the jurisdiction of each, preference to be given to those societies whose members have suffered badly from the vagaries of the preceding season. The period for which the amount would be loaned would have to be longer in the case of Co-operative Banks than that of the others, say for 9 months, because of the nature of an advance for agricultural operations. Besides, as emphasized previously, the rate at which this amount is to be loaned by the Co-operative Banks to Societies will have to be fixed by the Reserve Bank. If the experiment proves successful, larger amounts may be loaned either free of interest or at a nominal rate of interest.

Secondly, in addition to the above amount to be given away for the specific reason stated, the Rural Credits Department will grant advances for a period of nine months in the ordinary way, either directly or through its Agent, the Imperial Bank of India.

But the security against which the loans or advances are to be made will have to be different from that demand-

ed for commercial or trade transactions. For the financing of seasonal agricultural operations no documents 'evidencing title to goods which have been hypothecated,'¹ are available. The financing commences with ploughing and the only documents which could be obtained would be a *lien on crops*. Loans to the agriculturists are given on personal *credit* with securities or mortgages and such loans are required *at or just before cultivation time*. The Indian Central Cotton Committee (referred to above) came to the conclusion, after statistical inquiry, that "Practically the only borrowings made by cultivators are those taken at or just before the commencement of cultivation operations. Loans are generally not taken subsequently e. g., at harvest time. Certain dues which are to be paid off by a fixed date are usually paid out of the sale proceeds of early pickings."² The lesson to be drawn from this inquiry is that it would be rare to find promissory notes of Societies being supplemented with documents giving title to goods which have been hypothecated to them.

If then financial assistance to the cultivators is to be made possible, the Rural Credits Department should be permitted by Law to give advances on the promissory notes of the Societies which have been endorsed by the Co-operative Banks, specifying a *lien on agricultural produce*. In the words of Mr. A. F. L. Brayne "The basis of the Co-operative movement is the honesty, character and credit of the individual cultivator and any provision which substitutes hypothecation of goods for this security is opposed to the fundamental principles of the move-

¹ The Gold Standard and Reserve Bank of India Bill, 1928, 17 (e).

² General Report on Eight Inquiries into the Finance and Marketing of Cultivators' Cotton, Page 10.

ment.”¹ It would indeed be involving the Reserve Bank in risks if it was permitted to advance money without any hypothecation of goods as security, but these risks could be minimised by the endorsement of a Co-operative Bank and by limiting the total amount that the Rural Credits Department may loan annually on such security. If financial relief is to reach the Indian cultivator, risk has to be undertaken by the Reserve Bank to a reasonable extent.

There will be also another source of finance. Where bankers' acceptances are introduced, (as suggested previously) the Reserve Bank by buying them will finance the Co-operative Societies and the latter will thereby tap the resources of the central money market and the connection between the up-country money market and the central city money market will tend to be brought about (as shown in Chapter XII).

It is also by purchase, sale and rediscounting of bills of exchange and promissory notes of the co-operative banks and societies that the Reserve Bank will extend financial help to them. (Reference was made to this particular subject in Chapter IV.) But with the Imperial Bank of India dethroned from its present position as Government Banker, the facilities provided by it at present to the Co-operative Banks should not be discontinued. The same and even better accommodation will have to be given by it as an Agent of the Reserve Bank of India. Further, in places where there is no branch of the Imperial Bank of India, there is no reason why a Co-operative Bank should not be thought deserving to work in a small place as the Agent of the Reserve Bank. It would be the instrument in bringing the small up-

¹ Memorandum on "Relation between the Co-operative Banking and the proposed Reserve Bank of India" submitted to the Finance Department.

country place in direct touch with the Reserve Bank and would obviate the necessity of a joint stock bank opening a branch which it could not presumably afford to do in a small place.

In Chapter XII the subject of constructing warehouses and their service in supplying marketing credit was discussed. Such warehouses owned by the Reserve Bank would be of great use in enabling the Co-operative Sales Societies to pool the produce and obtain credit on it easily and quickly.

RELATION OF THE RESERVE BANK WITH LAND MORTGAGE ORGANIZATION :—The second part of the Rural Credits Department has to deal with long-term credit to agriculture. But the functions of this part would be confined to (a) the issue of debentures for Land Mortgage Banks, (b) the general supervision of the credit of such banks and (c) general control of these banks.

(a) Land Mortgage Banks usually raise funds by the floatation of debentures. But the floatation would meet with a ready response if a central financing institution like the Reserve Bank were to issue the debentures in India. Being in intimate contact with the money market of the country, the Reserve Bank can, on the one hand, use its great influence *to tap wider sources of finance* for the issue of debentures, and on the other, it can know best the *time* and the opportunity most suited for such an issue. Besides, being the best judge of changing money conditions and interest rates it could float debentures successfully from time to time at the lowest rates possible. And as the issue will be centralized in the hands of a single institution there will be no competition between the issues by various provinces. The amount or the debentures issued

by the Reserve Bank will certainly depend on the demand for them from the various Provincial Governments in India.

At this stage a diversion is needed. A few important points regarding the institution of Land Mortgage Banks in India may be stated, for they will have a bearing on the function of the Reserve Bank. (1) Each Province shall have a *single* Land Mortgage Bank based on co-operative principles as recommended by the Royal Commission on Agriculture in India, because the small Land Mortgage Banks in the Punjab and Madras formed on a co-operative basis have worked well and are found suited to this country. (2) The Government of each Province must definitely guarantee both *the principal and interest* of debentures. This will have the advantage of making the debentures a gilt-edged investment and lowering the rate of interest at which money can be obtained, and making the issue so successful that it would not be necessary for the Government to subscribe to the debentures even in the earlier stages of the Bank. Such provision has been wisely made in the State Land Mortgage Bank which it is proposed to institute in Ceylon.¹ If the principle of debentures is also guaranteed by the Governments of the Provinces, investment in land mortgage debentures would become a favoured long-time investment on the part of institutions such as Trust Funds and insurance companies in India and there would be no difficulty in attracting funds for the Banks.

If, however, each Provincial Government were to assume this responsibility, it must have a sufficient number of representatives on the Board of Directors nominated

¹ Report of the State Mortgage Bank Committee, Ceylon; July 1929; Page 4, Part II.

by the Governor-in-Council to ensure safe management ; these should be gentlemen of special knowledge and experience in the different subjects of land mortgage credit.

TYPICAL LEGISLATION IN CEYLON :—A second very important matter in connection with this assumption of responsibility by the Government is emphatically stated by the Ceylon State Mortgage Bank Committee. In their report they state “it is of the first importance that Government should be in a position to get notice at the earliest possible moment if things are not going on too well. We understand that this is just what has not happened in the case of some of the Co-operative Provincial Banks in India. Owing to certain defects in the system of accounting it has been possible for one at least of these Banks to carry on with every outward appearance of prosperity for years after it had really reached a point at which it should have been wound up.” They, therefore, considered two matters as essential.

(1) The Bank shall keep two accounts, the *capital* account and *revenue* account. These two accounts shall be kept *absolutely and entirely separate and distinct*. No moneys shall be transferred from one account to another account, nor shall either account be overdrawn except in stated conditions.

(2) Secondly, the guiding principle for the successful working of a Land Mortgage Bank is that *debentures should only be issued against mortgages*. Therefore *a balance must be automatically maintained to secure that the total sum borrowed by the Bank on debentures never exceeds the total loaned by the Bank on the security of the mortgages*. As mortgages are executed debentures can

be issued up to the total of the principal of the loans so secured.

(3) And all monies received as instalments of principal repaid shall be utilized for *the redemption of debentures* only. The Committee considered this scheme to be better than that of establishing a sinking fund invested outside the Bank into which sufficient proportion of all recoveries of principal should be paid for the redemption of mortgages. This was because the latter scheme would not be found practicable "as the interest obtainable on such an investment would be less than that which had to be paid on the debentures."

ASSOCIATIONS OF BORROWERS IN THE UNITED STATES :—The next question is : to whom would the Land Mortgage Bank loan the money—to individuals separately or those combined in the form of Associations? The better plan would be to follow the example of the United States of America and let the borrowers combine into small Associations for the purpose of borrowing money on land mortgage.

In the United States they are called "National Farm Loan Associations." The Act states (1) "Ten or more natural persons who are owners, or about to become the owners of farm land qualified as security for a mortgage loan by the Act, may unite to form a National Farm Loan Association."¹ (2) These may be organized by persons desiring to borrow money on farm mortgage security. Such persons shall enter into articles of Association. (3) The liability of the share-holders is *individual*. (4) Each Association elects 5 Directors who choose the Secretary and Treasurer. (5) Only a borrower of farm land mortgage can be a member of the Association and has to

¹ The Federal Farm Loans Act of July 17th, 1916.

subscribe to an amount equal to 5 per centum of the face value of the desired loan, to be paid in cash. (6) And whenever an Association desires a loan on first mortgage from a Federal Land Bank it has to subscribe for capital stock of the Bank to the amount of 5 per centum of such loan to be paid in cash which the Bank keeps as collateral and returns at par to the Association upon full payment of the mortgage loan. (7) The association is paid commission on interest payments of one-eighth of 1 per centum.

LAND MORTGAGE LOAN ASSOCIATIONS FOR INDIA :—In India, land mortgage loan associations can be formed with the help of the existing co-operative societies who could do a twofold service. They could explain to the villagers the advantages of borrowing on land mortgage security for the betterment of their economic position, and they would be the best instruments to bring prospective borrowers into Associations.

Associations would be advantageous both to the borrower and to the lender. The ignorant village borrower would not know whom to approach, how to do so, what procedure to follow and so on for a loan. But all these difficulties would be removed if he became a member of the Association, which would settle all the necessary preliminaries for him and enable him to secure a loan. In the present condition of cultivators in India the formation of small associations of borrowers seems almost imperative if land mortgage credit is to reach them. Besides, an Association would be a very useful instrument for giving information about particular lands, for endorsing mortgages, for collecting instalments of principal repaid and the interest on the loan and paying these into the Land Mortgage Bank, and above all of keeping accounts

on behalf of the borrower. Without an association and its secretary to undertake the work incidental to a land mortgage loan it would be extremely difficult for a bank to arrange a loan with the cultivator, who is not only ignorant but whose land is situated miles away.

THE LAND MORTGAGE BANKING ORGANIZATION IN THE UNITED STATES:—In the United States of America the organization established for land mortgage banking is as follows :—

At the bottom are the National Farm Loan Associations of borrowers (referred to above) who borrow from 'Federal Land Banks' which are 12 land mortgage banks instituted by the Government in the country. Each of these banks is to be temporarily managed by Directors appointed by the Federal Farm Loan Board (to which reference will be made shortly). These Directors shall cease as soon as subscriptions to stock in any Federal Land Bank by National Farm Loan Associations shall have reached \$ 100,000 when the new directors will be elected by the Associations.

In addition, the Associations can also borrow from 'Joint Stock Land Banks' which are corporations for carrying on business of lending on farm mortgage security and issuing farm loan bonds formed by any number of natural persons not less than ten.

To control the whole organization the Federal Farm Loan Board is constituted by law. Its members are appointed by the President and one of them is the Secretary of the Treasury.

THE CONTROLLING POWER OF THE RESERVE BANK COMMITTEE:—Similarly, a supreme controlling body is necessary, particularly if the essential principles to be observed in land mortgage bank-

ing, referred to above, are to be introduced. This can be adequately supplied by the Rural Credits Department for Land Mortgage Banking. The Committee of this Department will have powers of general supervision and audit over the various Banks to be established in the Provinces. The Committee may, like its counterpart on the co-operative side, consist of three members. The President is to be nominated by the Governor-General-in-Council and may preferably be a retired judge of the High Court, because decisions will constantly have to be given on most delicate and important points arising out of the title to landed property of borrowers and other legal matters. Of the other members, one may be nominated by the Reserve Bank Board and the other may be a representative of the Indian Provincial Co-operative Banks' Association. Both these should be men possessing special knowledge on important subjects bearing on different spheres of land mortgage banking, such as land values, notarial work, ordinary banking, and a general knowledge of rural economics. The Committee may appoint supervisors, auditors and appraisers.

But in order to place the controlling power in the hands of this Committee of experts legislation must lay down that the Reserve Bank *alone* will have power to float debentures for any Land Mortgage Bank in India. No other body, even it be a Provincial Government, shall have the power to issue such debentures. By such legislation the Reserve Bank will wield indirect power to float further debentures for a particular Bank, unless, according to the Committee's judgment, certain matters needing correction are not corrected by the Directors. This power of refusal will have a salutary effect on the efficiency of the management of the Bank.

CHAPTER XIV
THE RESERVE BANK OF INDIA
AND THE SHROFF

(Indigenous Banker).

BULK OF FINANCING INTERNAL TRADE.

A considerable bulk of the internal trade of the country is financed by the indigenous banker. There are no official statistical data to give any idea as to the extent of the business done by indigenous bankers. As stated previously the total volume of internal trade is estimated at Rs. 9000 crores, and in view of the fact that the total deposits of all banks were Rs. 212 crores in 1927-28, it can be seen that a very small proportion of financing is done by the Joint Stock Banks. But even comparing the clearance of cheques from the Clearing Houses (which may be taken as a test of the financing done by Joint Stock Banks) with the volume of internal trade, it will be found that the clearance formed only 18 per cent. of what was required in the country in 1927-28.

THE PRINCIPAL TYPES OF INDIGENOUS BANKERS :—The indigenous banker is found in every village, town and city in India. He is an institution which has existed in India for hundreds of years. He is still the chief instrument of the circulation of money and commodities in India. The Census Report of 1921 shows 9,93,000 persons as being dependent on banks, engaged in the business of credit, exchange and insurance. There are many types of them, and they are so variously named in different provinces that confusion is inevitable. For

clarity of exposition it is best to divide them into two *principal* types. (A) The money-lender or the *Sahukar* (or called the *Mahajan* or Bania) and (B) the Private Banker or the *Shroff*.

The first of these, the *Sahukar*, the rapacious money-lender, has already been dealt with in the preceding chapter. The functions and value of the *Shroff* will be considered in this chapter.

CLASSES OF SHROFFS:—The functions of a *Shroff* are practically the same as those of Joint Stock Banks, with one important exception that he does not as a rule use cheques. There are three classes of *Shroffs* or bankers : (1) those who are pure bankers ; (2) those who are bankers and commission agents and (3) those who are principally merchants and traders and who have banking as their subsidiary business. The largest number of *Shroffs* belong to the second category.

A distinction will be made between the private banker or *Shroff* of a *small town* (or *mofussil*) and the city *Shroff*, for whereas the former has little opportunity of coming in contact with a Joint Stock Bank, it is the latter who connects the trade with it.

(A) *The Mofussil Shroff*:—The *mofussil Shroff* is generally a *merchant-banker*. He trades principally in different commodities and keeps banking as his subsidiary line of business. He reminds one of the early provincial bankers in England and the London goldsmiths. These played a similar part but later abandoned trading, but the *Shroff* has still remained a *merchant-banker*. The nature of his trading differs according to the commodities dealt with. He accepts both time and demand deposits, but these form a small proportion of his working capital and little use is made of cheques.

CLASS AND FORMS OF HUNDIS :—The most popular and extensively used instrument of credit of the Shroff is the *Hundi* or domestic bill of exchange. The promissory note is seldom used for trade purposes, being generally utilized for private borrowing and lending. The cheque is very little used.

There are two principal classes of hundis.

(1) Traders' hundis or genuine hundis drawn *against goods*, and

(2) 'Hand' hundis or pure finance paper

(i) used as accommodation hundis as when a debt is contracted, the debtor writes or draws a hundi on himself which thereby serves as a pro-note ;

(ii) used largely for the purposes of remittance of funds from one part of the country to another.

Hundis may also be classified according to their *period of maturity* into (1) sight bill or *Darshani* hundi and (2) deferred bill, payable after a specified period, or *Muddati* hundi. The period varies from 11 days to one year.

The special peculiarities of the hundi concern the *payee* stated on it. The payee may be either (1) a specified person or (2) "a person of credit and substance in the market" and may be made payable (3) 'to bearer' or (4) 'to order'. Thus each 'sight' and 'deferred' hundi may have any of the above characteristics and consequently the hundi is named differently.

However, the hundi which is made payable to 'a person of credit and substance in the market' is not merely unique but has the widest currency. It is called *Shahajog* hundi. The legal implication is "that a person 'a drawee' paying a *Shahajog* hundi is expected to make reasonable enquiries about the holder before making the payment. At least he

must not pay a stranger.”¹ The risk is the drawee’s in making payment and the drawer and other intermediate parties after him are secure. On the other hand, the drawee relies on the fact that he is paying a known Shah or Shroff or merchant so that if a defect of title is subsequently discovered he can get his money back.”¹

AS A MERCHANT :—As a merchant, the Shroff is the real instrument in the distribution of agricultural produce and manufactured commodities in the country. He buys the produce from the village *Sahukar* and sells it locally in other towns to other Shroffs and dealers. Or he buys directly through his agents from the regulated markets established in different centres. The agricultural produce travels through the village *Sahukar* to the small Shroff and from him to the big Shroff and through the latter to local dealers and ultimately to the consumer. But the process is reversed in the case of cloth and other commodities manufactured at home or imported.

FINANCING OF THE MARKETING OF CROPS :—The Shroff is the chief instrument in financing the marketing of crops. Suppose a merchant in Khandwa wants to despatch cotton to Bombay. He sends it on *consignment basis* to a Shroff in Bombay (who is also a commission agent) and draws a hundi immediately for nearly 90 per cent. of the value of the cotton. After it is sold, a hundi for the remaining 10 per cent. is drawn. The Bombay Shroff may directly finance the dealer through his agent at Khandwa by an advance and receive the goods through the agent.

Or a Shroff at Khandwa may finance the dealer by paying him in advance from 75 per cent. to 90 per cent.

¹ Memorandum of Marwadi Chamber of Commerce to the Bombay Provincial Banking Enquiry Committee.

of the value of the cotton and despatch the cotton to another Shroff who is also a commission agent in Bombay. The mofussil Shroff also advances money to the cultivator or the dealer against goods which he holds until such goods are sold.

FINANCING AGAINST INSTRUMENTS OF OWNERSHIP :—Generally, the instrument of ownership employed for raising finance during marketing is the *Railway Receipt* (and the Bill of Lading to a small extent). Delivery orders too are issued in forward contracts but their use is not general, and except in Calcutta and to a very small extent in Bombay, they are not commonly used for raising seasonal finance. There are no licensed warehouses in India and therefore no warehouse receipts as security for receiving finance, but *godowns* are extensively made use of in the United Provinces and the Punjab and godown receipts are utilized for advancing money.

FINANCING SHOPKEEPERS :—The Shroff also works as commission agent for merchants desiring to buy commodities for their shops. He gives credit to his customer and directly purchases commodities for him either from wholesale dealers locally or from the bigger centres and delivers them and receives commission from both parties. He also discounts the hundis of his customers.

In short the Shroff as a merchant or a commission agent is the principal factor in the distribution of commodities in the country ; and as a banker, the real source of receiving credit by the merchants and shopkeepers of the mofussil. By his business in hundis he extends not merely considerable credit but saves the transmission of actual specie from place to place. He is the popular banker of the great majority of business men, because he has his

office in their vicinity, he has knowledge of markets for various commodities, he is courteous and willing to receive his customers at hours suited to them, and above everything else, his intimate acquaintance with the business men of the town enables him to gauge their credit quickly and to grant accommodation to them without fuss and formality and without the rigid insistence on security akin to Joint Stock Banks. Besides he deals with them in the vernacular language and in instruments of credit which they can read or write on.

FINANCING INDUSTRIES :—The financing facilities afforded by the Shroffs also to industries are considerable.

The cottage industries and small factory industries are mostly financed by Shroffs. The bigger factory industries also receive financial help from them in various ways. Thus they subscribe shares of manufacturing companies and accept deposits of shares and give loans against them. They also purchase and hold debentures of industrial concerns and give loans either against the general security of the total mill property or against particular parts including products of mills. They also join managing agencies of mills as financiers.

The Shroff has little scope for giving his services in financing foreign trade, as this business is practically the monopoly of foreign banks in India.

HIS IMMENSE VALUE IN CENTRALIZED BANKING :—If better credit facilities have to be extended by the Reserve Bank of India to agriculture and the internal trade of India, the most important instrument for the purpose would be the mofussil Shroff. If the Reserve Bank has to adjust adequately the volume of credit to the volume of business within the country and

thereby make its credit policy effective, it cannot afford to leave out of its scope the Shroff with the enormous volume of business which he finances and that great tradition of useful service which he has built up for generations in India. On the contrary, the Reserve Bank has to use the Shroff as its *secondary reservoir* in the mofussil through which it can pump its credit into the numberless small business houses in India.

(1) *Instrument for extension of credit in busy season* :— In placing the difficulties of the Shroff before the Bombay Provincial Banking Inquiry Committee, the representatives of the Bombay Shroffs' Association said, "The chief handicap under which the Shroff was working now was the insufficiency of capital and his difficulty in obtaining credit. Private finance, in order to enable it to meet the increasing demands of trade, ought to be supplemented by State money." In the scheme proposed previously,¹ it was suggested that the Reserve Bank might loan in the beginning Rs. 1 Crore, free of interest, from the Government balances during the busy season to indigenous bankers as an experiment. This proposal reinforces the remedy suggested by the Bombay Shroffs' Association. If the experiment proved successful larger sums might be extended in the future. But for the success of the scheme and for the Shroffs' eligibility for sharing its benefits there are certain essentials to be obtained.

THE REQUIREMENTS TO BE SATISFIED BY THE SHROFF :—The Shroff ought to be put on the Reserve Bank's 'Approved List'. The conditions for such recognition would be (1) that the Shroff should prove by document that on an average for at least the past five years he had a working capital of at least Rs. 1 lakh ; (2)

¹ See Chapter X.

that he had done a particular volume of banking business (the minimum to be determined by the Reserve Bank Board) and (3) that he is doing or is willing to do *purely banking business* (4) that after satisfying the above conditions, he deposits a certain percentage of his capital and deposits as security with the Reserve Bank (which shall fix the percentage); (5) that he submits to periodical examination of his accounts by the Reserve Bank; (6) and that the amount of the loan (to be given free of interest) to the Shroff, the rate of interest at which he can advance it to business men during the busy season, and the conditions under which he can be permitted to do so are all determined and laid down by the Reserve Bank.

The place of a single Shroff, if one is not found to fulfil the requirements, may be taken by an association of Shroffs of a particular mofussil town uniting to form a *Shroffs' House* for the same purpose and producing the required guarantees.

With the fulfilment of the above conditions, *elasticity could be given to credit during the busy season by the Reserve Bank* through the instrumentality of the Shroff, who is in closest contact with the numerous business men in the mofussil.

(2) *As an Agent of the Reserve Bank*:—The second way in which the Shroff may be made serviceable to the Reserve Bank is by his appointment as its *Agent* in a mofussil place where *no branch of a bank exists or could exist* for want of sufficient business. But it would be better if more than one Shroff combined, wherever possible, to form a syndicate or partnership.

(a) Each member would have to subscribe towards the capital of the syndicate. (b) The capital whether of a single Shroff or of a Syndicate should *not* be less than at

least Rs. 1 lakh. A certain proportion of the capital would have to be deposited with the Reserve Bank as security. The same would hold good for a single Shroff. (c) Each Shroff or Syndicate would have to give a *guarantee for a minimum amount of business which he or it should undertake* in a place and submit to an examination of accounts by the Reserve Bank. (d) The Reserve Bank, on its part, should lend money equal to the amount of business guaranteed by the syndicate and pay commission on the banking and agency business at different rates prescribed. (e) The Reserve Bank should also readily rediscount the Hundis which are *certified* by the 'Agent—a Shroff or a Syndicate. (f) the Bank should institute its godowns and put them in charge of the agents. Limitations would also have to be placed on the agents, whether a single Shroff or a Syndicate. (1) They would have to be *prohibited* from doing any private business with the Bank's money or to use the Bank's godowns to store their goods. (2) The maximum rate of interest at which the agents should loan the Bank's money would have to be fixed. (3) And in order to *protect* the borrowers from the evils of a monopoly, the *maximum* rate at which the Syndicate can loan *its own money* would also have to be limited by law. The connections of the agents with the Reserve Bank would strengthen their credit and make them popular.

The combined credit of a Syndicate of Shroffs could offer better security to the Reserve Bank and would be of assistance to it not merely in doing its agency work efficiently and in extending its credit to the innermost part of the country, but would be the source of bringing to the portfolio of the Reserve Bank an increasing number of hundis.

AS AN ACCEPTING BANKER OR ASSOCIATION :—In discussing the requirements for the establishment of a Bill market for India,¹ reference was made to the formation of Acceptance Associations by the Shroffs. It may here be repeated that Bankers' Acceptance will be the most suitable instrument of credit for the development of business and trade in the country. It may appear paradoxical that in a most illiterate country a most highly developed instrument of credit could be successfully introduced. But as explained previously, its greatest virtue is simplicity ; it can be standardized and is not likely to be as difficult to understand as are the hundis current to-day. Besides, its economic advantages are so easily realizable that even in the up-country market it will be quickly taken up. But for its introduction Accepting Bankers or Acceptance Associations are necessary. It would indeed be difficult to induce the mofussil Shroff to throw out his merchant business and become transformed into a purely banking institution in order to become an Accepting Banker, or along with other Shroffs, an Acceptance Association. However, if such an institution is possible, bankers' acceptances would be made to grow in number considerably and a Bill market for India could be established. But if the mofussil Shroff cannot be induced easily to become an Accepting Banker, his contemporary the city-Shroff can be made to do so, for he is generally a pure banker.

(B) *The City Shroff* :—In the city *Shroff* is to be found the only link that brings the small traders and business men in contact with the Joint Stock Banks of the country at present. He is also instrumental in supplying the link

¹ See Chapter XII.

between the indigenous bankers and the Banks, although it is a loose one.

Generally, the city Shroff is a dealer in *hundis* and in this respect it is possibly more correct to regard him 'as the counterpart of the London discount broker.'¹ But there are differences. The Shroff attracts *deposits* from individuals on which he pays higher rates of interest than the bankers, and uses them along with his own capital in order to give accommodation to traders and shopkeepers. He is the middleman who brings the discount business for the Banks who cannot hope to get in touch with the small business men except through him. He knows these business men intimately, is nearest to them and can deal with them in their vernaculars. He can therefore estimate their credit correctly. He does not insist in demanding rigid security from his clients, who are therefore willing to go to him for business. His system of accounting is nothing less than the modern double entry system.

He invests his own money or the deposits he has received in *hundis* and goes to the banks for assistance only when his resources are strained during the busy season. The turn-over of the business of the Shroff is very large. Even at present the total of daily cash receipts and payments of the Shroffs in Bombay would exceed that of the corresponding figures of the Joint Stock Banks.²

Generally, the city Shroff does not deal directly with the trader or the shopkeeper but gets into contact with him through another middleman, the hundi broker. If a shopkeeper wishing to stock more commodities in his shop

¹ Spalding: Dictionary of the World's Currencies and Foreign Exchanges, Page 173.

² Memorandum submitted by the Marwadi Chamber of Commerce before the Bombay Provincial Banking Enquiry Committee, October, 1929.

wants accommodation, he approaches a Shroff and the latter grants the accommodation if he is satisfied that the business is safe and if a hundi broker is found to act as an intermediary. If a single Shroff does not grant the advance in full, the hundi broker may approach other Shroffs and between them arrange for the whole sum needed. A hundi is taken by the Shroffs for the advances. The *hundi* broker receives commission from the shopkeeper for arranging the accommodation.

The Shroff also purchases *hundis* of smaller Shroffs in the same city, and the latter in their turn may have financed still smaller shroffs in other towns and so on until the smallest unit, namely, the village money-lender or grain-dealer or goldsmith is reached. In this way the city Shroff feeds up-country business with the finance needed. The city Shroff also gives short credit locally against railway receipts, which is not in the nature of commission agency business.

RELATION BETWEEN SHROFF AND SHROFF :—Shroffs give temporary accommodation to one another by giving short credits or call money. They have their mutual, fixed and current deposit accounts called '*Byaj Badla*' and '*Khata Peta*' respectively. The current account ('*Chalu Khata*') contains both deposit and loan accounts between Shroffs, and the moneys deposited or borrowed must be returned when the lending shroff wants them back. In the fixed or '*Byaj Badla*' account, the period of the deposit or loan and the interest thereon are fixed. The rate of interest for mutual borrowing among the Shroffs is cheaper than for other individuals and merchants.

FINANCING INTERNAL TRADE :—The city Shroff also plays a leading part in financing internal trade.

He finances his mofussil constituents either through his branch agent by a direct advance or pays them, as stated above, from seventy to ninety per cent. of the price of the goods against railway receipts by honouring the hundis drawn by them. The advance stands until the goods are sold on behalf of the constituents by the Shroff working as a commission agent.

He also purchases commodities in the city on account of his mofussil client and pays the seller the price for them immediately and receives money from the client on delivery of the commodities.

THEIR RELATION WITH JOINT STOCK BANKS :—The amount of accommodation obtained by the Shroffs from the Joint Stock Banks is limited. It is mainly received (i) on demand promissory notes signed by *two Shroffs* on their 'approved list' or by one Shroff and one merchant, or (ii) by discounting the hundis of an approved merchant which are *endorsed* by a Shroff on the 'approved list.' The period for which such finance is obtained is generally *two months* and each Joint Stock Bank advances money up to *a limit which is fixed for each shroff*. The shroffs also receive accommodation from the banks on the security of Government Loans or Share certificates.

When the demand for accommodation on the Shroff is greater than he is able to meet out of his own money, he is obliged to seek the help of the banks. He takes some of the bills he holds to, say, the Imperial Bank of India which discounts them on the *endorsement* of the Shroff. The rate at which the Imperial Bank will discount first class three months' bills is the *Imperial Bank hundi rate*. But whether the Shroff presents 'trade hundis' or 'hand hundis' to the Bank, *no documents* are tendered by him

in support of the paper. Naturally, therefore, the Bank becomes careful in discounting them, but more so in the case of 'hand hundis', for it is impossible to know if these represent a genuine trade demand, whereas 'trade hundis' at least indicate that some quantity of goods exists against which the *hundi* is created. The *personal standing* of the Shroff forms the real basis for discounting the hundis and the Bank has an elaborate system of *limits* whereby the amount of bills described for each Shroff is carefully watched. For instance, "scrutiny is applied to the names of the makers of the paper which the Shroff endorses; the frequency of the same name may, and does, cause Banks to reject paper made by such parties even though it may bear the endorsing Shroff's signature."¹ The endorsement of the Shroff does not signify *acceptance* on his part in the sense explained in Chapter XII. His business does not consist in *accepting* but in investing his funds in *hundis*.

The limit up to which any one Shroff may grant accommodation in the bazaar is dependent on two factors: (a) during the off-season, the limit which he himself places on the transactions with the hundi brokers and (b) during the busy season, the limit to which the banks would discount hundis bearing his endorsement.

THE RATES OF DISCOUNT :—The difference between the Shroff's own rate of borrowing money and the rate at which he lends it in the form of hundis is his profit. The rates charged by the Shroff are dependent on his *own resources*, on the demand for money *in the bazaar* and on the *standing of the borrowers* at a particular time. So long as the Shroff has enough funds of his own to invest in hundis, he does not need to go to banks for

¹ The Indian Year Book.

the discounting or rediscounting of the paper he possesses. The bazaar hundi rates have therefore no relation with the Bank rate (of the Imperial Bank of India). Besides, as the Banks themselves depend on the Shroffs for their discount and rediscount business, they do not compete with the latter. Consequently, the bazaar hundi rate does not ordinarily depend on the Bank rate.

But during times of stringency, as when the seasonal movement of crops or of imported goods begins, the bazaar hundi rate is dependent on the Bank rate to some extent, because during the busy season the Shroff's own supply of funds is not adequate to meet the demand. He, himself, therefore discounts hundis of his customers at a rate which is higher than the Bank rate and then rediscounts these *hundis* at the Imperial Bank at the Bank rate, and thereby makes a profit.

During the dull months of the year, the Shroff has in hand probably more money than he can invest in hundis, so that he is in a position to discount the hundis at a lower rate than that of the Imperial Bank, which he disregards completely. Finding no better field for investment during the off-season, the Shroff is anxious to invest his money even at unremunerative rates. But he tries to make up for the deficiency by charging proportionally much higher rates during the busy season. This therefore, accounts for the large variations in the rates during the year.

The diagram (p. 304) shows the variations in the Bazaar hundi rates and the Imperial Bank hundi rates during April 1927 to March 1928.

FACTORS WHICH MAKE HIM INDEPENDENT :—There are, then, two factors which account for the independence of the Shroffs as regards the fixation of the rates in the bazaar. (1) The principal factor is that they

themselves have considerable funds to supply the needs of the market and it is only when these funds are completely invested that they go for help to the Banks and (2) the financial help obtained from the Banks to meet the market needs forms merely a fraction of what is supplied by the Shroffs, and that too during times of stress.



Variations in the bazaar hundi rates, the Imperial Bank hundi rates and call money rates in Bombay, during April 1927 to March 1928.

These factors lead to the corollary that the bazaar rates are little influenced by the credit policy of the Banks. At present the only indirect way in which the Imperial Bank can make its credit policy operative to a small extent is through *the issue of currency*. The demand for credit in the bazaar must *eventually* depend for its satisfaction on

the supply of currency which is to be had from the Imperial Bank (and through it from the other Banks).

HIS SERVICE TO THE RESERVE BANK :—

With the institution of the Reserve Bank in India, there will be different ways in which the city Shroff will be of indispensable service in enabling it to exercise control over its credit policy. In the first place, if the Shroff is willing to be treated as a *Banker*, he can be brought within the control of the Reserve Bank by the enforcement of the *compulsory* reserve rule. In this case, then, he will have, like the Joint Stock Banks, to deposit a fixed percentage of the time and demand deposits which he attracts from the public. But legislation in his case must be kept *voluntary* for a few years ; and the facilities to be offered by the Reserve Bank must be so attractive that the Shroff would be induced to come within its fold. The facility can take the form of funds readily given out to the Shroff on the 'approved list' at a low rate of interest during times of stringency for investment in hundis. The amount to be so offered may be fixed for each Shroff according to his past business dealing with the Imperial Bank of India. Besides, if a city Shroff has got branches in the small mofussil towns where there is no branch of any Bank, they could be recognised as the Agents of the Reserve Bank, in which case they would share the benefits under the prescribed conditions stated above.

Some city Shroffs, however, may be willing to cast off the deposit and lending business in order to form themselves into a pure Discount House and thereby give birth to an institution which would be an indispensable link in the formation of a Bill Market in India. But the new alternative is only possible when, (as stated in the chapter on the Bill Market for India) the habit of drawing

bankers' acceptances has progressed sufficiently and enough of them circulate in the country to make their discounting a profitable profession.

However, the formation of Acceptance Associations by the Shroffs with their branches in the mofussil would be the finest institution not merely for financing up-country credit but for linking the up-country money market with the city money market, and consequently enabling the Reserve Bank to attain its ideal of bringing within its credit control the mofussil money market as well. How this could be brought about and what its results would be have already been explained in Chapter XII. To conclude, the Shroffs' greatest service in the development of credit in India will be in their transformation as Accepting Bankers or Associations.

A CERTIFYING INSTITUTION FOR HUNDIS:—Another asset for building up a Bill Market in India would be the *Hundi*. As stated above, the only hundi which is accepted by the Joint Stock Banks is the trade hundi, so that it is not possible for the banks to discount a sufficiently large number of them. If the hundi is to form an asset, it should be *standardized*. The principal Banks and Shroffs may at a joint conference approve a particular form which would be given recognition by law and could be readily discounted or rediscounted by the banks.

But if there is established in every city an institution of Shroffs, such as the Bombay Shroffs' Association, which shall serve also as a *certifying* institution for Hundis, the present difficulties regarding discount and rediscount of them would be removed and greater encouragement would be given to their use. Every member of such an institution would be a recognised Shroff whose endorsement on

a hundi must serve as a guarantee to the Joint Stock Banks, who should discount it without question. The Shroff's endorsement will give the hundi the 'hall-mark' of quality. Once the endorsement of a Shroff of a certifying institution is affixed to a hundi, whether it is a trade hundi or usance hundi, it would readily be accepted by the banks because the endorsement would carry with it not merely the responsibility of a single individual but the *accumulated guarantee of the whole institution or association*. If the hundi is dishonoured, it is the Association which should be held responsible for its payment to the Bank. The Association, on its part, would safeguard its interest in various ways. For instance, a particular number of years' standing as a Shroff and a particular amount of business done by him may be laid down as a minimum qualification necessary for membership. Besides, like the Bombay Share Bazaar Association, every Shroff desiring to become a member must be made to buy a card of entry, and the amount so received would form the reserve to meet any dishonoured hundi certified by him. The institution would also keep a register of business men who are certified by the individual Shroffs to be of good standing and whose hundis would therefore deserve certification. With such a certifying institution, not only would the usance hundis be received by the Bank, but their use could be developed and greater accommodation provided for the bazaar by the increased facilities for rediscount.

CHAPTER XV

HISTORY OF THE RESERVE BANK LEGISLATION

The bill to establish a Reserve Bank for India had a chequered history. It passed through nearly five stages in its career when ultimately it was dropped. If a detailed account of the discussions of the Legislative Assembly on the Bill were to be stated, they would be found to constitute the constitutional history of the Assembly during those eventful months when the Bill was before it. However, it is not the object of this book to deal with this aspect of the Bill, although the important arguments for and against certain principal clauses of the Bill have been stated. A short account of the various stages of the Bill is given with a more or less complete abstract of the Report of the Joint Select Committee, which played the most vital part of the history of the Bill.

PART I.

History of the Reserve Bank Bill.

STAGE 1.

"The Gold Standard and Reserve Bank of India Act," 1927.

The first Bill with the above title was formally placed before the Legislative Assembly by Sir Basil Blackett, the Finance Member, on the 25th January, 1927, when he moved the circulation of the Bill. The Bill gave effect to the recommendations of the Royal Commission on Indian Currency and Finance, 1926, and in its essentials followed them closely. In principle the Reserve Bank was

to be a *Shareholders' Bank* and gave the Imperial Bank of India as an institution and not to its individual shareholders (as recommended by the Royal Commission) the option of subscribing thirty per cent. of the capital. The Board of Directors was to consist of fourteen members, of whom 5 were to be nominated by the Governor-General-in-Council (including the Governor and the Deputy-Governor of the Bank) and 9 were to be elected by the shareholders. As the Bill was minutely dealt with and altered by the Joint Committee, all other important details are included in their Report to which reference is made. After several members had made introductory speeches Sir Basil Blackett moved reference of the Bill to a Joint Select Committee of the Legislative Assembly and the Council of State with a membership of 28 members on 25th March, 1927, because he wanted all the best brains available to consider the Bill and the Imperial Bank Act Amendment Bill. The House adopted the motion and three days later the 14 members who were to represent the Legislative Assembly were appointed.

The Joint Committee first held its sittings in Bombay from the 30th May to 4th June and later in Calcutta from the 18th July to 25th July.

On each occasion 25 members out of 28 were present and signed the Report.

STAGE 2.

Report of the Joint Select Committee.

The members of the Joint Committee, to which the Bill to establish a gold standard currency for British India and constitute a Reserve Bank of India was referred, considered the Bill, and submitted their Report with the Bill as amended by them. They made a number of

changes in the Bill, several of considerable importance, but although they attained unanimity on a large number of matters of importance, certain of the decisions were not accepted by the minority.

The fundamental changes which were embodied in their Report were as follows :—

(A) *The 'State Bank' principle adopted* :—The most important alteration made was the substitution of a Bank with *capital supplied by Government* in place of a Bank with private share capital. The change is stated thus :—

(i) 'The original capital of the Bank shall be five crores of rupees which shall be *subscribed by the Governor-General-in-Council.*'

(ii) 'The capital of the Bank may, with the previous sanction of the Governor-General-in-Council, be increased or decreased in such manner and to such extent as the Board thinks necessary and any such increase of capital shall be subscribed by *the Governor-General-in-Council.*'

The embodiment of these clauses meant the institution of a *State Bank*. The reasons which led them to favour this change were as follows :—

(i) 'In the first place, it was thought that a banking institution, the primary object of which was the control of the credit and the finances of the country would, if directed by a body responsible only to a number of private shareholders, *tend to be controlled by vested interests*, and would, therefore, *fail to secure the confidence of the Indian public*; and that its utility to the public might even be endangered by a conflict of interest within the management of the Bank between Indian and external capital.'

(ii) "Secondly, we consider that joint-stock principle is not suitable in the case of a Central Bank, the management of which should be carried on with an eye more to

the public interest than to the accumulation of profits for shareholders.’’

(B) *Who were to be the Directors constituting the Board?* The second important change made was with regard to the administrative body which should control the Bank. A twofold change was introduced, one negative, the other positive.

(i) In the first place, they *omitted the provision prohibiting members of the Indian or Local Legislatures from being nominated or elected as Directors of the Bank.* They considered that such a provision would deprive the public of the services of a considerable number of those who are versed in public affairs and finance. They did not agree with the view that a member of the Legislature would by reason of only occupying that position, be unable to fulfil his duties as a Director of the Bank.

(ii) Secondly, although they agreed to the provision of the original Bill that Directors of Banks should be excluded from being Directors of the Reserve Bank, they found the case of Co-operative Banks different and provided that there should be no bar to the inclusion in the Board of Directors of Co-operative Banks.

(iii) Thirdly, the Committee added a clause providing that no person shall be eligible either for nomination or election to the Board, who is or has not at some time been actively engaged in agriculture, commerce, finance or industry.

They made it clear that a person who is or has been a director of any company or corporation shall be deemed eligible under the clause.¹

¹ In the Bill as amended by the Committee the following explanation is given to make this point clear:—“A person who is or has been a director of any company as defined in clause (2) of Section 2 of the Indian Companies Act, 1913, or of a corporation or company incor-

(iv) The Committee, then, designed a scheme for the constitution of the Board in place of the original shareholders' scheme. It was such that a *majority* upon the Board of *Indian elected members* was ensured. The Board, as reconstituted by them, was to consist of :—

(A) *Four members* who were to be nominated by the Governor-General-in-Council of whom there were to be (1) a Governor and deputy Governor, *one of whom was to be an Indian*, (2) two Directors, who were to be Indians.

(B) The other Directors were to be *elected* as follows :

(i) *two* by the Associated Chambers of Commerce ;

(ii) *two* by the Federation of Indian Chambers ;

(iii) *one* by the Provincial Co-operative Banks ;

(iv) *three* by the *elected members of the Indian Legislatures*, of whom one shall be elected to represent the interests of commerce and industry ;

(v) *three* by the *elected members of the local legislatures*, of whom two shall be elected to represent the interests of agriculture and one of commerce and industry ; and one officer of the Government appointed by the Government. The inclusion of directors to be elected by the elected members of the Legislatures was made on the ground that such members represent together all the various interests of the *people as a whole* and that it was reasonable and just that on the Reserve Bank there should be some Directors elected by such *general electorates* in addition to the special interests represented on it.

(C) Then there were various limitations placed on the discount operations of the Reserve Bank.

(1) *Limitations on discount operations of the Bank* :—
With regard to its business of discounting bills *directly*,

porated by or under any law for the time being in force in any place outside British India shall be deemed to be or to have been actively engaged in commerce, finance or industry."

the Committee restricted it to those *drawn and payable in India* and arising out of *bona fide* commercial or trade transactions, bearing two or more good signatures and maturing within 90 days from the date of such purchase or discount, exclusive of *days of grace*. But a proviso was laid down that such business could only be undertaken if sanction was given by *not less than two-thirds of the Directors* present at the meeting of the Board who thought that such action was necessary or expedient *in the interests of Indian trade and commerce* or for the *purpose of enabling the Bank to perform any of its functions under the Act*. Indeed this function is necessary in order that the Bank may be enabled to enforce its discount policy. But in order that the Bank might *not enter into indiscriminate competition* with commercial banks, not only was the sanction of a majority of the Board made necessary but the purposes for which they could approve the undertaking of such operations were also to be indicated.

(2) The function of purchase, sale and *rediscount* of bills was limited to those bills *drawn and payable in India* and maturing within 90 days exclusive of days of grace and bearing two or more good signatures one of which was always to be that of a *scheduled bank*.

This restriction was placed in order to give to the scheduled banks some *compensating advantages* for the obligation imposed upon them by the Bill to maintain compulsory deposits free of interest with the Reserve Bank.

Besides, considering the fact that India is predominantly an agricultural country, the Committee raised the limit of bills and notes purchased or rediscounted (drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops and maturing within six

months from the date of such purchase or rediscount exclusive of days of grace) from one-fifth of the total value of all bills and notes so purchased or rediscounted to *one-quarter of the total*.

(D) In the original Bill, full discretion was given to the Bank to purchase and sell the currencies of any foreign country having a gold standard. But the Committee found such a wide discretion undesirable and confined it to such countries having a gold standard as the Governor-General-in-Council designated for the purpose.

(E) *A gold mohur to be introduced*:—Yet another change of vital importance proposed by the Committee was the introduction of a *standard gold coin* which they called a *mohur*. They found this necessary because they desired that the transition to a gold standard should be conspicuously marked and that it was only by the introduction under a statutory enactment of a legal tender gold coin that the reality of the gold standard could be brought home to the public.¹

But they did not find it possible to give the public the right of having gold bullion coined into *mohurs* at the mints and consequently left the amount of *mohurs* to be coined at the absolute discretion of the Governor-General-in-Council.

They also decided to re-establish the Sovereign and half-sovereign as legal tender in India. The rupee value of the sovereign was fixed at Rs. 13 1/3 with the proviso that they were not precluded from raising the question of the ratio at the stage when the Bill as amended was taken

¹ The standard weight of the *Mohur* was to be 188.366 grains troy, and its standard fineness was to be nine-tenths of fine gold and one-tenth of alloy. Its equivalent rupee value was to be Rs. 20 and bank notes were to be of the denominational values of one-quarter mohur or five rupees, one-half mohur or 10 rupees, and so on.

up for consideration, as such was the desire of some members.

(F) *The Reserve* :—Among the clauses referring to the Reserve which was to form the Assets of the Issue Department of the Bank, it was laid down in the original Bill that “of the total amount of the Reserve, *not less than two-fifths shall consist of gold coin, gold bullion or gold securities*” and after the end of the tenth year it shall not be less than *one-quarter* of the total amount of the Reserve.

But the Joint Committee laid down the conditions that :—(a) the amount of gold coin and gold bullion *shall not at any time be less than Rs. 30 crores in value* ;

(b) after the end of the tenth year, at least *one-half shall consist of gold coin or gold bullion*.

The object in making this amendment was to ensure that the free flow of gold into India should not be checked by any tendency on the part of the Reserve Bank to substitute gold securities for coin or bullion.

(c) They also raised from 50 per cent. to 85 per cent. the proportion of gold coin and gold bullion held in the Reserve which *must be kept in British India*. They agreed that under certain circumstances it might be advisable to allow gold belonging to India to be located outside India but they thought that 15 per cent. was quite sufficient for that purpose. The proposal to raise the proportion was also the result of their recommending the prohibition of the sale of gold by the Bank for delivery outside India.

(d) Reference has already been made to the limitation placed on the purchase and sale of currencies of foreign countries in (D). Following upon that decision the Committee decided to limit the holding of gold securities in the

Reserve to securities which were not only payable in the currency of a gold standard country whose parity with gold had been firmly established but which were also liabilities of such a gold standard country. But all these were to be subject to the sanction of the Governor-General-in-Council and were to be :—(1) balances at the credit of the Issue Department of a Central Bank or with any of the Federal Reserve Banks in the United States of America ;

(2) securities maturing within 5 years, of the Government of any part of His Majesty's dominions which is a gold standard country ;

(3) sterling securities of the Government of India.

(e) The remainder of the Reserve shall be held in rupee coin, Government of India securities of any maturity and such bills of exchange and promissory notes drawn and payable in *British India* as are eligible for purchase by the Bank under the sections laid down.

It is important to note that the Committee *omitted* the provision of the Bill which allowed the holding in the Reserve of bills of exchange drawn on *foreign* gold standard countries, because they thought that such a provision was unnecessary and an undesirable feature of the gold reserve.

They also increased each of the limits of the amount of rupee coin which might be held at various periods in the Reserve, which was not to exceed Rs. 50 crores at the end of ten years or one-tenth of the total amount of the Reserve, whichever amount is greater. This increase was recommended on the ground that as the rupee coin and bullion in the Paper Currency Reserve had increased by 23 crores as compared with the amounts so held at the time at which the Royal Commission had made the recommendation, it would clearly be impossible, without a

radical disturbance of the silver market of the world, to get rid of the surplus silver within a period of ten years.

(g) *Sale of gold and gold exchange* :—Another important change was made by the Committee regarding the sale of gold and gold exchange by the Reserve Bank. They replaced the obligation to sell *gold* at *foreign centres* by a *permanent obligation to sell gold exchange* in any gold standard country notified in their behalf by the Government of India. Two important advantages were claimed as the cause of this provision ; (1) they considered that the obligation imposed on the Reserve Bank to keep the value of the internal currency stable would be made capable of fulfilment by this provision and (2) that it would make it possible for a greater proportion of gold to be held in India.

As regards the quantity of gold to be bought and sold by the Bank, the original figure for a minimum purchase or sale was 1,065 tolas, which was based merely on the fact that the weight of commercial bars in London is 400 ounces. But the Committee reduced this figure in both cases to 250 tolas as being a figure more suited to Indian conditions.

(h) *Scheduled Banks and their cash Reserves with the Reserve Bank* :—In the Bill the obligation to maintain balances with the Reserve Bank was imposed only on a limited number of the more important banks in the country. But the Committee concurred with the opinion of the Royal Commission that, if the Reserve Bank were to exercise its proper control over the credit system of the country, this obligation must be extended as widely as possible and should fall upon *every* bank in British India and recommended the same accordingly. The balance which each bank was compelled to keep with the Reserve

Bank was to be no less than $7\frac{1}{2}$ per cent. of the *daily average of the demand*, and $2\frac{1}{2}$ per cent. of the *daily average of the time liabilities* of such bank in India. And for this purpose, the *daily average* of the amounts of the demand and time liabilities of each scheduled bank was to be computed in respect of each period ending on the fifteenth and on the last day of each month. This clause was inserted to facilitate the computation of the requisite proportion of the liabilities and in so doing the example of the Federal Reserve System of America was followed.

Two qualifications were imposed by the Committee for the inclusion of a bank on the list of scheduled banks—(a) that it is a company as defined in clause (2) of section (2) of the Indian Companies Act, 1913, or a corporation or company incorporated by or under any law in force in any place outside British India, and (b) that it has a paid-up capital and reserves of an aggregate value of not less than Rs. 3 lakhs.

(I) *Agreement with the Imperial Bank of India* :—They also made two important amendments in the provisions to be contained in the agreement between the Reserve Bank of India and the Imperial Bank of India, which was to be the sole agent of the former.

In the first place, they reduced from 25 years to 20 years the period during which the Imperial Bank should be entitled to claim balances free of interest or at a nominal rate of interest, although they maintained the period of 25 years as the period during which the contract should be in force.

Secondly, they omitted the clause which provided for additional payments in respect of the opening of additional branches, as apprehension had been expressed that pro-

vision of that kind might prove detrimental to the interest of indigenous banking.

The Committee made *no* change in the payment to the Imperial Bank of India by the Reserve Bank of India of a commission which was to be calculated on the total of the receipt and disbursements dealt with annually on account of Government by the Imperial Bank of India on behalf of the Reserve Bank of India. Such commission was retained at $1/16$ of 1 per cent. on the first Rs. 250 crores of such total and $1/32$ of 1 per cent. on the remainder.

MINUTES OF DISSENT :—The Minority Report was signed by Sir Basil Blackett and seven other members and its essential points were supported in separate minutes, but for almost identical reasons by three others (making a total of *eleven* members out of twenty-five).

They held fast to the scheme of a private capital bank and strongly opposed the majority plan of providing 11 out of 15 Directors of the Board who would owe their presence on it to State intervention as unsound and undesirable on various grounds.¹ They were also opposed to the proposal of the Majority to restore the sovereign and half-sovereign as legal tender and to the coinage of the gold *mohurs* and to express notes in terms of *mohurs* as well as rupees. Objection was also raised against the majority's proposals in regard to the amount of gold securities in reserve.

STAGE 3.

The amended Bill before the Legislative Assembly.

The proposals of the Majority were incorporated in the Bill which was brought before the Assembly on August

¹ As the Arguments of the Minority are included in Part II of this chapter they have not been stated here.

29th, 1927. In moving for consideration of the amended Bill Sir Basil Blackett elaborated the Government's objections to the scheme which were embodied in the Minute of Dissent to the Joint Select Committee's Report and himself put forward a scheme which, he claimed, was 'a fair reconciliation of the different opinions expressed.' The scheme related to the Governing Board of the Bank which was predominantly Indian; the nominal value of the Shares was to be Rs. 100/- and the dividend was fixed at 6 per cent. cumulative. This was laid down to enable small subscribers to subscribe to it, thereby ensuring a wide distribution of shares in Indian hands. The strict limitation of the voting power of large shareholders would prevent the bank falling under capitalist control. Nine Directors were to be elected by the shareholders by a system of 'Single transferable vote' thereby ensuring the representation of a wide variety of opinion and interest among the shareholders. The Federation of Indian Chamber of Commerce, the Associated Chambers of Commerce and Provincial Co-operative Banks were each to elect one director. Three Directors were to be nominated by the Government of India in a way which would protect the interests of agriculture and of localities and communities which might otherwise go unrepresented.

The debate on the amended Bill went on and various speeches were delivered supporting the Majority's scheme. On the third day, Sir Basil Blackett announced that the Government would give up the shareholders' principle and concede to those who advocated a State Bank if election by the Legislatures was definitely excluded and a satisfactory directorate framed. Such a concession, he said, the Government was willing to make "on the understanding that the Bill will clearly have to

live or die according to our success in coming to a conclusion on clause 8 in finding a satisfactory directorate.”¹ In this connection one of the leaders of the Congress Party, Mr. Shrinivasa Iyengar, had already tabled an amendment in which he proposed to institute a system of ‘Electoral Colleges’ in place of the shareholders as electors.

About this scheme Sir Basil Blackett said, “There is an amendment on the paper for electoral colleges which was put down after it had been discussed with me and which, I must confess, appeals very strongly to me personally. It seems to me a better solution than any that has hitherto been put forward, and the Government are willing to accept that solution in principle. They do not desire at this stage to tie themselves down to particular details because they are anxious that the solution that is found should be one which is acceptable very nearly un-animously to every quarter of the House.”²

The consideration of the Bill, clause by clause, was then taken up and that embodying the State Bank principle was first passed.

On the 1st September, when the clause 7 relating to *disqualification* for directorship was placed before the Assembly Sir Basil Blackett moved an amendment that *members of the Indian or Local Legislatures should also be disqualified from becoming directors*. After lengthy arguments for and against such a disqualification (which are stated in Part II of this chapter) his amendment was rejected by 70 votes to 51.

Then another important clause taken up for debate concerned the appointment of the Governor and the

¹ Legislative Assembly Debates, Vol. IV, No. 53, Page 3702.

² Legislative Assembly Debates, Vol. IV, No. 53, Page 3778.

Deputy Governor of the Bank. Sir Basil moved the *deletion* of the provision inserted by the Joint Select Committee that either the Governor or the Deputy Governor of the Bank must be an Indian. As the debate on this amendment had not concluded by 2nd September, he moved on that day an adjournment of the debate on the ground that as no agreement had been reached on the point of directorate to be elected by the electoral colleges as suggested by Mr. Shrinivasa Iyengar, there seemed to be a danger of the Bill foundering and he thought it would be much better "in the interests of all that the Government and the leaders of the Parties should have a period over the week-end to consider whether this seemingly threatening cloud can be dispensed without any undue storm."¹ On the leaders of the various Parties expressing their approval of the motion it was carried.

But when the House again met on the 5th September, it was found that the Government had not included the item on the agenda, nor was there any explanation forthcoming why this was not done.² At the next meeting of the Assembly Sir Basil Blackett announced the decision of the Government that they had no intention of proceeding further with the Reserve Bank Bill at present. This sudden announcement was resented by the non-official members as an 'affront' offered to the House, particularly after seven clauses of the Bill had already been passed by the House.

On 13th September when the House reassembled a motion censuring the Government of India for withdrawing the Reserve Bank Bill from the consideration of the House at that stage in a sudden and abrupt manner

¹ Legislative Assembly Debates, Vol. IV, No. 53, Page 3905.

² Stated by the Hon'ble the President while giving his Ruling on 1st February, 1928.

was discussed and carried. In explaining the attitude of the Government on that motion Sir Basil Blackett said, "I entirely agree that the Government has no right to withdraw the Bill without coming to this House. If members of this House are of opinion that an affront has been offered to the House, I can say on behalf of the Government of India that no such affront was desired or intended and that I am very sorry that any impression of that sort should have gone abroad. As regards the withdrawal of the Bill, what the Government has done is to come to the conclusion that, *in view of the time available during this Session and the complexity of the problem still to be solved, it was not desirable to attempt to complete the Bill this Session.*"¹

STAGE 4.

A New Bill Refused.

After the Simla Session of 1927 closed, Sir Basil Blackett went to London to discuss the Bill with the India Office and returned in time for the Delhi Session of 1928. When the Delhi Session of the Legislative Assembly opened on 1st February, 1928, Sir Basil Blackett rose to introduce a *new* Reserve Bank Bill which *reverted to the Shareholder principle*. (*The Bill is given in the Appendix at the end of this Book.*) But a great constitutional question was immediately raised. The old Bill had been partly discussed in the last session and the House had decided on its principle and seven of its clauses had been passed. Was Sir Basil right in bringing before the Assembly a Bill dealing with a subject which had not been finally decided and which the Assembly was in possession of? Mr. Patel, the President of the Assembly, gave his con-

¹ Legislative Assembly Debates, Vol. IV, No. 60, Page 4285.

sidered ruling and refused sanction to its introduction, basing his decision on the precedents of the House of Commons, which, he said, applied with greater force to this case, since material alterations were proposed to be made in the Bill as amended by the Joint Select Committee and in the decisions already reached by the House. He declared: "I unhesitatingly affirm that the method proposed to be adopted by the Finance Member violates the proprieties of the House and is an abuse of its procedure." He referred to the publication of the new Bill in the Gazette of India under orders of the Governor-General-in-Council which had rendered the position of the Assembly very difficult. "This procedure", he said, "has deprived the Assembly of an opportunity of refusing the same subject as a protest against the method adopted by the Government in dealing with the Reserve Bank Bill."

STAGE 5.

The Old Bill Proceeded with and Dropped.

The Government, therefore, decided to proceed with the 'old Bill "and try to have it amended, where necessary, in the Council of State."¹ On 6th February an amendment providing for two deputy governors and omitting the statutory provision that one of them should be an Indian was proceeded with by the House. It was put to the vote and carried by 53 votes against 45. Sir Basil Blackett then moved for the elimination of the clause providing for three directors being elected by the Indian Legislature, which after considerable discussion, was put to the vote and carried by 51 votes against 49. Sir Basil Blackett then moved the deletion of the sub-clause giving Provincial Councils the right to elect three Directors and

¹ India in 1927-28, Government Publication.

his amendment on being put to the vote was carried by 50 votes to 49. Thus three amendments were won by the Government.

But when the President put to the House, that clause 8, as amended, be passed and ordered a division, it was lost by 50 votes to 49. As soon as the result was declared Sir Basil Blackett said the Government had to consider whether the House wanted the Reserve Bank Bill at all. The President thereupon adjourned the House.

On the 10th February, Sir Basil Blackett announced the decision of the Government to drop the Reserve Bank Bill which was unanimously accepted by the House on the 13th February.

PART II.

Shareholders' Bank or State Bank Principle?

The various arguments used by the Members of the Legislative Assembly against the embodiment of the shareholders' principle and state ownership principle in building up the constitution of the Reserve Bank of India will now be summarily stated with the object of placing before the reader not merely both the official and non-official points of view, but the basis on which a constitution could be proposed which would command the greatest compromise on the one hand and win the confidence of the people on the other. The points in dispute concerned the *nature* of this Bank and the *character* of the directorate.

ARGUMENTS IN SUPPORT OF THE SHAREHOLDERS' BANK :—Sir Basil Blackett, in support of his proposal for a Shareholders' Bank, put the following arguments :—

- (1) "It was fundamental", he said, "to the idea of a Reserve Bank that it should be *completely inde-*

pendent of the Government and the Legislature, free to conduct the business of the Bank on lines of prudent finance and in accordance with the directions of the Statues under which it came into being, without being subject to any, direct or indirect political influence. The question of share capital in these circumstances became largely a question of commercial and expediency.” But he said, “it is indeed difficult to see how the Board of a Bank, the whole of whose capital is subscribed by the Government, can be made entirely independent of it.”

- (2) Sir Basil, then, laid stress on the *task of framing a suitable plan and securing a suitable Directorate* that would work efficiently, which he said, was extraordinarily difficult unless the device of shareholders was adopted. This device (of shareholders) he said, had various merits :—

(i) ‘It has the merit of making the members of the Board responsible for money which they themselves have contributed out of their own pockets and responsible to shareholders to whom they are accountable for the money which they have contributed out of their pockets and not merely responsible to their own consciences.’

(ii) ‘It has the further merit’, he said, ‘of *providing a ready-made constituency for the selection of a representative Directorate.....* We want a Board of capable and businesslike men, of wise and mature outlook, fully conscious of their immense responsibilities, a Board with full and sympathetic understanding of Indian requirements and widely representative of India as a whole, a Board which will devote itself whole-heartedly and in single-

mindfulness to the business of making a success of the control of currency and credit in the interests of India, a Board which will be *Indian in outlook and largely Indian in composition*; how can such a Board be framed?..... In the absence of shareholders it is very *difficult to frame a constituency wide enough to secure representation of the whole of India*. We do not want them at all to represent narrow or sectional interests. The Board (in the case of a State Bank) cannot be answerable to the Government and in the absence of shareholders there is no one to *jog the conscience* of the Board when it becomes too easy going."

- (3) Sir Basil also preferred the Shareholders' plan on the ground that it was "one which would be understood in the rest of the world, and the rest of the world will feel that in dealing with the Reserve Bank of India, it is dealing with something which it can understand and whose constitution it can appreciate."
- (4) But the real point of dispute centred round the method of selecting the Board and the responsibility of the Bank towards the State. The method of appointment of the personnel of the Board suggested by the Joint Select Committee, referred to above, contained an important provision that some members were to be elected by the Central and the Local Legislatures. In opposing this provision in the Assembly Sir Basil said: "If the difference of opinion is on the question whether the Legislatures are to elect members of the Board, there I agree that the difference is real and irreconcilable..... It is not any suspicion of the Legislatures or any dis-

belief in their value. It is that the Government feel that in the first place it is not the proper constitutional path for Legislatures to take part in making appointments to special posts ; they are thereby *definitely overstepping the functions of the legislative and usurping those of the executive* ; but also that Members of the Assembly and of the other Legislatures are elected by their electorate for definite political purposes and to serve definite political ends. If they are elected by the same electorate for the special purpose of electing the Directors of this Bank, I have no doubt that they would prove an admirable electorate ; but as they are not, it is mixing up business and politics at the risk of both suffering."

- (5) The Joint Select Committee had also inserted a provision that Members of the Legislatures were eligible for membership of the Directorate of the Bank. Sir Basil raised very strong objection against this insertion and, as noted previously, he moved an amendment for its deletion which was lost by a large majority. However, in moving his amendment, he pointed out that the provision that Members of the Legislatures as such should not be eligible for membership of the Directorate of the Reserve Bank was among the unanimous recommendations of the Currency Commission and that it was a provision that was found in a considerable number of statutes of Central Banks throughout the world, the reasons for which were fairly simple. He said, "It is obviously desirable that there should neither be a definite intermixture of politics in the business of controlling currency and credit, nor

should there be any room for suspicion of such intermixture. This is perhaps even more important now that this Bank is to be not a Shareholders' Bank but what is called a State Bank."

- (6) He then considered his objection from the point of view of the *difficulty* involved in allowing a Member of the Legislature to work on the Board. "I am quite prepared", he said, "to admit that there are always likely to be a *considerable number of Members of Legislatures who are well qualified to serve as Directors of the Reserve Bank*. But it is desirable that they should make a definite choice between the two." If they were desirous to serve as members of the Directorate, he argued, they should be readily available for meetings of the Board, but the time they would have to spend at the sessions of the Assembly would not permit them the time and energy required for the performance of their duties as members of the Reserve Bank Board. "It is not proposed", he said, "that they should be disqualified for election, but if they are elected they must choose either that they should be Reserve Bank Board Members or that they should be Members of the Legislature." In concluding his arguments he very wittily said: "I would ask this House to remember that in voting on this amendment, it is considering to some extent a *self-denying ordinance*, and I think that in considering that as a self-denying ordinance it should give the benefit of the doubt, if it possesses any in its mind, to the virtues of self-denial."

HOW ARE THE ARGUMENTS ANSWERED?

Sir Basil placed before the House his fundamental prin-

principle governing the Reserve Bank thus : "It would be absolutely contrary to my whole notion of the Bank that the Government should exercise *any control whatsoever* over the Bank." But this principle has remained an ideal merely, as it is opposed to the existing facts in relation to Central Banks. These facts have been stated in sketching the constitution of the Managing Boards of the Central Banks of various countries. The constitutions of the Boards differ in details but the factor common to nearly all is the appointment of the Governor and his Deputy of the Bank either by the Head of the State or by the Government. "It is a matter of public knowledge" write Messrs. Kisch and Elkin "that the Governor of a Central Bank exercises a preponderant voice in shaping the general policy of the Bank".¹ The personality of the Government exists in the Governor and Vice-Governor of the Bank,² and in many Central Banks they are empowered to veto the decisions of the Board if they were not in the interest of the State. In addition, in some form or another, as shown previously, nearly every constitution provides that the Government shall exercise control over the management of the Bank and the best example is of the Federal Reserve System of America.

Besides, the very nature of the functions of the Central Bank makes Government control inevitable either directly or indirectly. As Pandit Madan Mohan Malaviya said : "The Honourable the Finance Member might repeat what he has just now said a hundred times, but he will not be able to persuade me that he means seriously that the

¹ Central Banks : Page 57.

² In giving an account of the control of the Govt. over the Bank of France Mr. Cecil H. Kisch said before the Royal Commission "The higher policy in finance as carried out by that Bank in *ordinary* times has been based upon the action and direction in the main of the Governor and Deputy Governors who are closely *lié* to the State." Vol. V, Page 72.

Government of India should not exercise any control over the management of such a Bank. If the Government were not to do so, it will fail to do its duty by this country.”

The claim that a shareholders' bank would completely divest the Secretary of State and the Government of India at least of a great measure of control of the Bank was *prima facie* well answered by the late Lala Lajpat Rai who, in refusing to accept it, said : “This Bank is not an ordinary corporation or company. The facts that in future it is going to control and manage the currency of the country, and that on many occasions it requires the sanction of Government and has to submit to Government control, show conclusively that to compare it with an ordinary corporation or company, whether it be a railway company or any other company, is entirely absurd. On every page of this Bill, Government control and Government sanction is practically written. This Bank when established is going to control the currency policy of the Government of India which will affect practically the interests of every inhabitant of India, whether he is represented on the Bank or not.”

DO SHAREHOLDERS CONTROL THE DIRECTORATE IN PRACTICE? But what has been the experience of the working of the numerous corporations, commercial banks and in particular Central Banks which are instituted on the shareholders' plan? Do the shareholders actually exercise control over the management? If they did so to a substantial extent, there would be justification for introducing the shareholders' plan. But the facts are otherwise. In the case of Central Banks the responsibility of the Directors to the shareholders is *eye-wash*. (i) In the first place, actual facts

show that an insignificant percentage of the shareholders attend the Central Meeting annually to 'elect' the Directors. To prove this fact, Mr. Vidya Sagar Pandya placed before the House a list of attendance at the General Meeting of the shareholders of the Imperial Bank of India for the years 1921-1926. It was a complete exposure of the so called 'control of the shareholders'. Out of the 5000 shareholders the gentlemen that actually attended during the respective years were 2 in person, 33 in person and 881 by proxy ; 41 in person and 1621 by proxy ; 16 in person and 908 by proxy ; 34 in person and 841 by proxy and 13 in person and 778 by proxy. And the late Lala Lajpat Rai showed that at the general meeting of the Bank held in 1927 only 3 per cent. out of the total voting strength of the Bank took part in the proceedings, "in spite of the extensive canvassing that was done by the Directors and officials of the Bank and that the point of view of the Indian Section was entirely neglected." And what are the facts concerning certain Central Banks in the world? To what extent the power of the shareholders is limited in the Bank of England has already been stated. But here additional evidence of Mr. J. M. Keynes may be stated. When he was asked by the Chairman of the Royal Commission to state whether it was a fact that in many important countries the Central Bank was more or less independent of the Government, he said, "It all depends whether you mean formally or informally..... You could not have a more extreme case than the Bank of England, which *formally* is a private company, but that does not represent the facts..... The Bank Directors have the power of resigning and making a great public scandal about it in the last resort, but in practice, short of a great public scandal, I should say

that *it is the Government of the day which has the last word.*"¹ In the Bank of France, out of 33,781 shareholders, (on the rolls in 1921) as stated before, merely 200 largest shareholders have the right to vote. As regards the Reichsbank, out of a total of 18,799 shareholders, only 30 were present at the general meeting held on the 5th March, 1914. This particular year was selected for inquiry because it was the year in which it had a normal constitution. The information received from four other important Central Banks of Europe² with a shareholders' constitution reveals a similar fact. At the General Meeting of the Banks in 1928 the number of shareholders who exercised the right of voting for the election of the Directors or Managers formed '4 per cent.', '7 per cent.', 'nearly 14 per cent.', and 'little under 15 per cent.' of the total voting shareholders.

(ii) An inquiry into the ownership of shares of many Central Banks of Europe will show that trustees of private trusts, rich families and big merchants form the largest holders of them. The trustees' principal care is to invest the trusts' money in gilt-edged securities like the shares of the Central Bank and do not care to take an interest in the management of the Bank. The same is true of rich families, many of whom are relations of 'high officials and dignitaries of the State' who are bound to support the Government's nominees on the Board, the Governor and the Vice-Governor, in their policy. And the merchants trading on borrowed capital are bound to form an asset to the Governor. In emphasizing the

¹ Answers to Questions—13054-13061.

² It is unfortunate that the author is not at liberty to publish the identity of the Banks either directly or indirectly. That is why the percentages merely are stated and not even the total number of shareholders in each case is given.

dependence of the merchants, Mr. Jamnadas M. Mehta referred to Mr. Hartley Withers' "Money" and said: "In another part of his book Mr. Hartley Withers points out that the directors, customers, and depositors in a bank are mainly *merchants trading on* borrowed capital; these people will never have the courage to stand up against the Governor and Deputy Governor on a point of policy. For if they did so, as Mr. Hartley Withers says, the next time they want accommodation they will be met with a frigid and discouraging countenance. And I would like to see in this world the commercial man who will have the courage to oppose the Governor and Deputy Governor who hold the strings of his solvency in the hollow of their hands". Thus, in the words of Mr. Vidya Sagar Pandya, 'the Directorate of a bank practically becomes a close borough confined only to certain favoured firms. The Directors by mutual courtesy have a freehold and life-long tenure of their offices... If there are any independent directors, they and their firms languish under the cold shade of the Secretary or Managing Governors' displeasure and their contempt is seldom purged. Under the present system, a seat on the direction of the Imperial Bank becomes apparently an asset in the partnerships of certain firms but is not a wise or a prudent one. The directors in a shareholders' bank in India have not much independence. In the hands of a strong Secretary or Managing Governor, they became dummies or pawns to play with. In short, the Bank is in the pocket of the Secretary or Managing Governor.'

In the annual Reports to be submitted before the General Meetings of shareholders is to be found, without an exception, "Directors X and Y retire by rotation but are eligible for re-election." And the gentlemen are

automatically returned and the election becomes mostly a farce.

(iii) Besides, it is commonly found that although the number of shareholders may be large, a handful of persons or firms own so many shares that if voting power is according to the number of shares held by an individual, a few individuals really have the control of the Bank or any other Joint Stock concern. But even granting the possibility of legislation limiting the shares to one share per individual only, in the case of the Reserve Bank of India, as Pandit Madan Mohan Malaviya said : "does anybody seriously think that these shareholders, scattered over all parts of the country, not having anything to bring them together and to educate them on these questions, not having the guarantee that as individual they will have the outlook that is needed in the management of the concern of a State bank, that these men will be able to work together and put on the directorate of the bank men in whom this Assembly can confide? I submit not."

(iv) And where is the guarantee that shareholders will elect as Directors those who are experts in the management of banking and currency of the country? Among the shareholders there may not be a single person fitted for the work of a Central Bank. How many shareholders know the problems of currency, exchange, banking and finance so well that they could bring their knowledge to 'jog the conscience of the Board'? Very few indeed, or none. The only possible way in which Sir Basil Blackett could have fulfilled his desideratum to secure by the shareholders' plan "a Board of capable and businesslike men, of wise and mature outlook, fully conscious of their immense responsibilities," would have been to provide by legislation that no one shall be a shareholder who did not

possess these virtues and give expression to them in actual life. Would that be a practical proposition?

In order to remove this deficiency, reference was made to the legislation of some Central Banks which, as shown previously, provide that special interests which are not shareholders, that is, representatives of agriculture, commerce, industry and banking, should be on the Board of Management. When it is found imperative to have these representatives for the successful management of the Banks, wherein lies the necessity and usefulness of shareholders? The existence of these special bodies proves on the one hand the *incapacity* of shareholders to manage the Bank, and on the other hand their *powerlessness* to make their influence felt on the Bank's management. What knowledge do the shareholders possess to question the judgments of these experts? It would be ridiculous to ask them to sit in judgment on specialists. And suppose a difference of opinion arose on an important point between the Government nominees and the representatives of special bodies. For whom would the shareholders vote? Surely, for the Government, because for the safety of their capital they would put absolute faith in them. If, however, they voted in favour of the special bodies, there is nothing to prevent the Government from declaring the point of dispute a case of 'national emergency', in which case the control of the shareholders vanishes.

DO THE INDIAN LEGISLATURES CONTROL THE EXECUTIVE? Sir Basil also opposed the provision that Members of the Legislatures shall elect some members of the Board, because he said they were thereby overstepping the functions of the Legislature and usurping those of the Executive. This raised a great constitutional issue.

Sir Basil would have been perfectly justified in his statement had India possessed the same political constitution as England or any other democratic country. *There is a fundamental constitutional difference between the relation of the Executive to the Legislature in Indian and in other democratic countries.* In these countries the Executive is an organic part of the Legislature. Members of the Executive must first be elected Members of the Legislatures and belong to the Party which is then in power. When the King or the President of the Republic calls upon a Statesman to form his Executive, it is because the latter belongs to the Party which is in the majority in the Legislature, which will have confidence in him. Therefore, the Legislature does not insist on making appointments to various posts and very rightly leaves that work to be done by the Executive, which is responsible to them for any action taken. If the Executive fails to satisfy the Legislature an adverse vote by the latter brings it to an end. Consequently, when the Executive makes appointments it really means that the Legislature, that is, the Party in power, does so. The Party in power is simply delegating its authority to a few of its best men with the conviction that its wishes will be carried out. If, then, the Legislature insisted on making appointments directly, it would be usurping the powers of the Executive.

But in India the position is entirely different. The Members of the Executive are *not* chosen from the Legislative Assembly. They are men *external* to it. They are *not* responsible to the Assembly. A vote of no-confidence against the Executive does *not* compel them to resign. There is also a new element in the Indian Legislature which is not to be found in the Legislatures of democratic

countries. A certain number of members of the Legislature are *nominated* by the Governor-General-in-Council. Finally, the Governor-General has the right *to veto* any decision of the Indian Legislature.

This is why the Legislature in India insisted on electing at least some members of the Directorate. Pandit Madan Mohan Malaviya explained the position thus : "I submit that the Legislature here stands on a different footing from the Legislatures in some other countries. Sir, this is a new experiment, and the Legislature has come into existence only recently. We have not many such institutions in this land as can be trusted to safeguard the financial interests of the country to the same extent, as for instance, the institutions in England can. The Central Legislature, the Assembly combined with the Council of State, I submit, Sir, is the custodian, the chosen and accredited custodian of the interests and the rights of the people of India at present. This being so, it has its duty to perform in seeing that any powers which are given to the proposed Bank shall be exercised under conditions which will satisfy it that the interests of the people will not be sacrificed..... But, Sir, if the Legislature is not given the power to elect its own representatives, what is there left to us?". At present he said, the representatives of the people could discuss the policies and the operations of the Government of India, but once the Reserve Bank was constituted and particularly if it were a shareholders' bank they would be met with the answer "Oh ! this is a matter for the Bank ; why should the Government be brought into it ? The Legislature has co-operated with the Government in bringing the bank into existence and has entrusted it with the power of dealing with all these questions. It is therefore improper for

the Government to interfere with its management by raising these questions here." In short, the Legislature would be entirely shut out, and he proceeded: "All the time the Honourable the Finance Member, whoever he may be at the time, will be certain that he will be able to exercise his influence over the management of the Bank through the Governor whom the Governor-General-in-Council will appoint and whom he has the power to dismiss. I submit, Sir, it will place the Assembly and the country in a very disadvantageous position. I submit it will mean that instead of a bank being run in the interests absolutely of the people of this country, the bank may be run and managed in such a manner as to disregard and sacrifice those interests without the Assembly having sufficient opportunity or the means of controlling or checking the operations of the bank. I do not think, Sir, it is fair to ask the Assembly to place itself in that position."

The same arguments were emphasized by most non-official members and the late Lala Lajpat Rai summed them up thus: "The fact, that these foreign countries have responsible self-Government and this country has not, makes it all the more incumbent that the popular representatives of the people in the Legislatures of this country ought to have a voice in making the Directorate of the Bank."

Sir Purshothamdas Thakurdas analysed in a different way the feature of 'political influence' which, it was argued, would be brought into the Directorate if the Legislatures elected a few members. He said: "It is admitted that political influence is one which should be avoided in every country which has full democratic institutions. There the party in power has all the patronage at its command, and therefore anything which may leave open

political influence means the influence of the party which has the patronage at its command. Sir, in this country if there is any person or institution which has that patronage, it certainly is not on this side of the House. It is the Government that have the patronage, it is the Government that can exercise political influence. The only difference is that my friends on this side of the House will not call that 'political'."

Mr. N. C. Kelkar also said : "The pretence is really funny that while the least touch of the Legislature with the proposed Bank spoils it by political influence and pressure, the combined nominees of the Government and the British commercial community in India will save the Bank from that influence and pressure."

At present, the Legislatures are empowered to elect some members to work as members on the various Finance Committees. Why is it then that the Legislatures are permitted to elect their representatives in moulding the finance of State Railways and other Departments? If the Legislatures can, without usurpation, elect their best men to serve on Finance Committees, what constitutional or moral objection prevents them from electing these men to the directorate of a Bank, which they will themselves help to create and which is to be a national institution for the success or failure of which they will be responsible to the electorates? Besides, to ask the Legislature to create an institution and make them responsible to the people for its good working *without giving to the Legislature any hand in its supervision or control* is constitutionally unsound. This was the fundamental argument on which the non-officials insisted on making a few appointments on the board. If the Executive in India were responsible to the Legislature as in other countries,

it would certainly have been a constitutional mistake on the part of the latter to tread on the privilege of the Executive in making appointments to the Directorate. But the Executive is not responsible to the Legislature in India at present.

And, after all, the non-official members of the Assembly claimed to elect only *three* directors out of a total of *fifteen*. This proves that they did not want to dominate the Directorate.

Another special feature of the Indian Legislature which distinguishes it from the Legislatures of other countries was emphasized by most non-official members, namely, its personnel. In the Indian Legislature sit not merely those who pay a certain amount of taxes annually and have a minimum period of residence in certain constituencies, but special *bodies, representing agriculture, commerce, industry, and other interests*, also have the right to send their representatives. *It is not then a purely political body* as in other countries, and has the services of the best men representing the widest constituencies and interests.

CAN MEMBERS OF THE LEGISLATURE BE MEMBERS OF THE BOARD? Sir Basil objected to members of the Legislatures being eligible for the Directorate of the bank on the ground that there should be no intermixture of politics in business, although there might be a considerable number of members of the Legislature well qualified to serve as Directors. Mr. C. Duraiswami Aiyangar answered the objection thus : "If only the Honourable Sir Basil Blackett would see a bit, he would find that according to his own proposal it is only those politicians who came into such legislatures that will be debarred from going in as Directors. There are

worse politicians outside the Legislature and they will not be debarred from the Directorate..... Sir, I find absolutely no logic or reason in such a distinction being drawn between a politician who is outside the Legislature and a politician who is inside the Legislature. Perhaps the Honourable Sir Basil Blackett himself will realize that the politicians within the Legislature are much calmer than the politicians outside the Legislature at present and will be glad if those who have been tamed in the Legislature are allowed to go into the Directorate rather than politicians outside the Legislature who have not yet been tamed.”

In repeating the same objection Sir Victor Sassoon said : ‘If a man is elected as a Director because of his business capacity, he would not allow the political side of his temperament to interfere with the business side.’ Mr. A. Rangaswami Iyengar appealed to experience and said : ‘‘I do not think our past experience in this respect has been in any respect wrong. We have here in this Legislature Members who are members of the Directorate of the Imperial Bank. Have we found Imperial Bank politics trotted out by these Directors in this House? I do not think any instance can be cited of that case. Therefore I refuse to believe that the Members of the Legislature by the mere reason that they are Members of this Legislature would be prejudiced either in discharge of the duties of the Central Bank or of the Legislatures.’’ Mr. Fazul Ibrahim Rahimtullah became more definite when he said : ‘‘In the general constituencies, you find that in the Local and Central Legislatures, you have constituencies like the European Chamber, the Bengal Chamber and the Indian Merchants’ Chamber. Why do business people come into politics, and why do Govern-

ment provide seats for them? If the Honourable the Finance Member says that politics and business should not be mixed, they should not get this right of sending a representative. Why do you want business men from the business constituencies to come here and advise you on business matters? If that is so, then we want our best men, who are on this and the Local Legislatures, to be also Directors on the Reserve Bank." Again he asked, "Do the Government mean to say that, because Sir Purshothamdas Thakurdas is a Member of the Legislature or Sir Maneckji Dadabhoy or Sir Dinshaw Wacha is a Member of the Legislature, that the work of the Imperial Bank has in any way suffered? Is it because of the experience that they have derived that the work of the Imperial Bank has suffered that they are coming forward with an amendment, which may, if I put it in the words of Sir Bhupendranath Mitra, create suspicion on the other side? Is it because Government wish to deprive us of the services of the best men available on this side of the House that they want to put forward this amendment?"

If at present a Director of the Imperial Bank of India has not lost his conscience and brought politics into business by being a Member of the Legislature, what special reason is there to expect a Member of the Legislature to lose his conscience and bring politics into business by being a member of the Board of Directors of the Reserve Bank?

But Munshi Iswar Saran asked: "Government will send up their nominees. Are Government—I put it straight—are Government a non-political body?..... Government is and will be a political body; Government will be influenced by political considerations and will be swayed by political moves. What is the good of saying

‘If you send your men, your men will be swayed by politics. What about the Government?’”

It is indeed true that many statutes of Reserve Banks debar a Member of the Legislature from becoming a Director of the Bank, but that is so for the reasons already advanced. On the contrary, there are Central Banks which do not do so ; for example, on the directorate of the Bank of England there are actually two Members of Parliament.

IS A FULLY REPRESENTATIVE BOARD POSSIBLE? It was also argued by Sir Basil Blackett that in the absence of shareholders it was very difficult to secure representation of the whole of India. If this were the principal motive, it could best be secured by the people’s representatives electing the Directors of the Bank. As Mr. Kelkar said, “The Assembly represented the collective wisdom of 50 million people and as there were divisions and groups in the House, election by such a body was sure to be the best.” “Members of the Central Legislature,” said Pandit Madan Mohan Malaviya, “have been elected on the electoral rolls kept by Government, they are elected under rules laid down by Government, they come from all parts of the country, and they are elected by a larger body of electors than will be found in any constituency that has been dreamed of so far in connection with this Bank..... They together constitute 134 electors.....and it is perfectly easy for them to propose 3 men whom they consider to be most qualified, most competent to look after the interest of the public. No other electorate is more certain to meet or to have the majority of its members meeting together than this electorate. And whom do they represent? These 134 members represent every considerable interest

in the land!" On the contrary, it is ridiculous to argue that the holding of shares by widows, trustees, rich families and so on, would secure representation of the whole of India. Would it be possible to lay down by legislation that in each Province each section of the people *must* subscribe to the share in order to secure a just representation of the whole of India? Where is the guarantee that particular interests will not hold a majority of the shares and thereby dominate the Directorate of the Bank? Is there any practical method by which this could be prevented?

SHOULD IT BE UNDERSTOOD BY THE REST OF THE WORLD? Another of Sir Basil Blackett's contentions in favour of a shareholders' plan was that it would be understood by the rest of the world. But does the rest of the world not understand the constitution of the Commonwealth Bank of Australia or the Bank of Sweden? A reply was given by Sir Purshotamdas Thakurdas to this argument. He said "What does it matter whether that is applauded by the rest of the world forthwith or not? The question is whether the institution is suitable to India or not? Is the institution going to be an institution which is to be devised and carried on, in the interest of India, which is to serve the needs of India? And if the rest of the world, owing to their ignorance of the problem of India, do not understand the *raison d'être* of the institution which is to serve Indian purposes and Indian needs, is Sir Basil Blackett going to sacrifice that part of our necessity to the attraction that the rest of the world will at least applaud the ideal?"

IF STATE OWNERSHIP IS A TRADITION WHAT SHOULD BE THE PRINCIPLE? In giving the criteria of State Banking, Messrs. Kisch and

Elkin state that 'if State ownership is a tradition soundly established by the country, a State Bank should in theory be as capable of carrying out a national policy as an institution of an independent or quasi-independent character.' But it is argued that "the danger lies in the weakness of human nature to resist the temptation of creating credit when the machinery is provided."¹

India has established a sound tradition of State ownership and State management in the Railways. "We have had", said Pandit Madan Mohan Malaviya, "long and painful experiences of company management. The railway companies are the first we have to remember. India lost between 800 and 1000 crores of rupees by the management of railway companies." And what is the position now? State management is bringing to the Exchequer nothing less than nearly Rs. 12 crores of net profits annually and Sir Charles Innes, the Member in charge of Railways, "acknowledged on the floor of the House that State management has proved very successful". So India has a tradition to fall back upon.

But the plea urged that in the case of a State Bank there is a danger in the weakness of human nature being tempted to create credit needs an answer. Granting the above possibility for a moment, it is as true that the State can, through the instrumentality of the chief officers of the Shareholders' Bank, do the same thing. The only difference is that in the case of a State Bank it can be done directly and openly, whereas in the case of the Shareholders' Bank it has been done indirectly and secretly, 'behind the *Purdah*', under the guise of a Bank 'independent of State control'. History lends support to this view. Out of the sixteen Central Banks of various countries

¹ Central Banks, Page 25.

based on the shareholders' plan, every one suffered from State intervention during and after the War and saw the greatest depreciation of their currencies. However, it is argued against these facts that the States had to resort to interference because the times were extraordinary—times of national crises. But it is only during a national crisis that both the shareholders' Bank and the State Bank are put to the test. Besides, whenever a State is in need of money there is nothing to prevent it from declaring it a time of 'grave emergency', whether the Central Bank is based on the Shareholders' plan or the State-ownership plan. If the men who form the Executive of a State and the Party to which they belong are selfish, they will be tempted 'to create credit', whether the Central Bank has for its basis the shareholders' plan or the State ownership plan. And why should the danger apply to the Central Bank only? All other institutions would suffer from a selfish Executive and more easily by such means as giving large contracts to vested interests, allocating taxes, creating new departments and posts for their own following and so on. Are these opportunities not tempting? If a responsible Government becomes corrupt, it need not be because the machinery lending itself to corruption is provided in the Central Bank. If those who control the State can be easily tempted, they do not deserve to control the State; it is the fault of the people who elected them and they must be thrown out. But once a responsible Government having the confidence of the people is formed it is illogical to argue that the Government would merit the confidence of the people in other departments but would lose its character in controlling a Central Bank. Besides, exponents of the principle of 'danger in weakness of human nature' as applied to

State Banks have not been able to give a single concrete example of that danger having manifested itself in the case of such banks. It is, therefore, an abstract theory as much applicable to a State Bank as to a Shareholders' Bank.

It is interesting to note that one of the authors (referred to above), Mr. Cecil H. Kisch, Financial Secretary at the India Office, in his evidence before the Royal Commission of Indian Currency and Finance (1926), proposed a 'Close association' and 'an effective voice' of the Government by the inclusion of 'a high financial officer of the Government capable of making the views of the Government felt' in a scheme for a Central Bank for India. He further suggested the right of 'suspensory veto' to be given to that official if the view was held that it would increase the confidence of the Indian public.¹ When asked by Sir Henry Strakosch why he held such a view, which was definitely counter to the one generally expressed by the Brussels and Genoa Conferences that Banks should be freed from political pressure, Mr. Kisch said that those Conferences "were held under the influences of circumstances in which Governments driven to desperation had grossly abused the principles of the note issue."

¹ Report—Vol. V, Qs. 11,621-11,623.

CHAPTER XVI
THE CONSTITUTION OF THE
RESERVE BANK OF INDIA

EXCHEQUER GRANT OR DEBENTURES AS CAPITAL:—The conclusion emerging from the debate on the Reserve Bank Bill is that there is no necessity for introducing the joint-stock principle in raising the capital for the Reserve Bank, either wholly through public subscription or through the State sharing in it. The capital required by the Reserve Bank will be for various purposes. Capital is needed to defray the preliminary expenses of the Bank and to begin with a reserve fund which would inspire confidence in the public. The Bank would also need funds sufficient to make credit elastic to help the money market, but these need not be a permanent liability. When, after a few years of successful working, it has accumulated profits out of which it has built up a large reserve fund, the Bank's necessity for holding the original capital would disappear. The original capital would be required only for a few years, and there is scarcely any reason for perpetuating that burden in any form of shareholding. Nor is it desirable that a Reserve Bank should be endowed with any very great amount of capital, because owing to the restrictions under which the Bank has to transact business, it might be difficult to utilize a substantial part of it in business, particularly due to market conditions, and capital to that extent might be wasted.

The best method of obtaining capital lies in a choice between a grant from the exchequer by the State, or the

issue of debentures by the Bank, or a combination of both as in the case of the Commonwealth Bank of Australia. The prime essential necessary for the issue of debentures is a statutory declaration by the Government that the Reserve Bank shall function under the guarantee of the Government. This secured, the debentures would be gilt-edged securities and a popular investment. The main features of their issue should be as follows :—

(1) The Debentures should be of small denomination, say, Rs. 100 each, in order that persons of small means may also get a chance of subscribing to them. With the same object in view, a maximum limit to the holding of debentures by a single person, or institution should be placed. This fixation of the limit would not be possible in the case of Bearer Debentures which have the advantage of avoiding the trouble of transfer from the name of one person or institution to another. In case regional banks are to be established on the Federal plan, a particular amount of debentures would have to be reserved for each region in order to give the people in the different parts of the country an opportunity to subscribe to them. The economic importance of each region would decide how many debentures should be allotted to it.

(2) Considering the present rate of interest on long-dated redeemable loans of the Government of India, it would be safe to propose the rate of interest on the Debentures to be $5\frac{1}{2}$ per cent., free of income tax, for it would be the most attractive rate.

(3) The period for redeeming the Debentures need not be more than 20 years, for if only 5 per cent. of the total debentures were set aside from the net profits of the Bank every year, the total would be made up in

20 years. A Redemption Fund would have to be established out of the net profits of the Bank for redeeming the Debentures.

I. UNITARY STRUCTURE OF THE RESERVE BANK OF INDIA :—It may be stated in favour of a unitary type of Reserve Bank for India that, since the existing Imperial Bank of India has spread its branches all over the country, it would find in the latter a well established and experienced Agent for the extension of its credit facilities. Besides, as stated previously, if the Reserve Bank has to pump its credit into the hundreds of small mofussil towns and still smaller units in India, it would find in the Shroffs or the Co-operative Credit Banks indispensable units to serve as its Agents.

Under the circumstances, then, if the Reserve Bank of India has to be a single unit, what should be the constitution of its governing body? Any scheme suggested must have some defects and in particular there may be some part of it which, while gaining the favour of one section of the community, may seem to go against the interest of others. A compromise is needed, but the chief aim must be so to establish the governing body that it would gain the absolute confidence of a large majority of the people and would not impair the freedom of the Reserve Bank in its transactions.

A SUPERVISING COUNCIL TO BE ELECTED BY A JOINT COMMITTEE OF THE LEGISLATURES :—In the first place, let the two Houses of the Central Legislature appoint a Joint Committee of, say, 30 members (15 from each) with a *majority of Indian non-officials* and, as far as possible, those who represent the various economic interests. This Joint Committee should appoint :—

A *supervising Council* of the Bank consisting of, say, 20 members, to be composed of :—

- (a) 10 members of the *legislature* of whom :—
 - (i) 5 should be officials, including the Finance Member and the Comptroller of Currency,
 - (ii) 5 should be non-official Indians.

and (b) 10 members who are *not* members of the Legislatures and are selected as experts in agriculture, commerce, industry, currency, banking, finance, accounts, economics, transport and law. A majority of these should be Indians. *The Finance Member should be the President of the Council. The Supervising Council should be responsible to the Central Legislatures.*

THE MANAGING BOARD :—The Managing Board should work under the control of the Supervising Council.

It should consist of, say, 12 members as follows :—

- (a) *Four* nominees of the Governor-General-in-Council consisting of :—
 - (i) The Governor and the Vice-Governor ;
 - (ii) An Officer of the present Currency Department ;
 - (iii) Another experienced Officer versed in Co-operation and land mortgage.
- (b) *Four* Indian members to be appointed by the *Supervising Council* of the Bank *from its own members*. But the members so selected must *not* be members of the Legislature or officials.
- (c) *Two* members of whom one is elected by the Associated Chambers of Commerce and one by the Federation of Indian Chambers of Commerce.
- (d) *Two* members of whom one is elected by the Provincial Co-operative Banks and one by the Indian Joint Stock Banks. But in the case of the latter

the member must *not* be either a director or an official of any bank.

The Manager in charge of each branch of the Reserve Bank should be appointed by the Supervising Council.

THE RURAL CREDITS DEPARTMENT :—

In view of the importance of agriculture to the national economy of the country it would be necessary to divide the management of the Reserve Bank into two main departments as in Australia :—

(a) The Central Banking Department.

(b) The Rural Credits Department.

The latter should be placed in charge of a Committee of three Directors, as proposed in Chapter XIII. The Central Banking Department might also be subdivided into (i) Issue Department, (ii) Banking Department and (iii) Branches Department. Three Directors would be in charge of each department by turns every year. But action could only be taken if approved by the Managing Board as a whole.

*POWERS OF THE SUPERVISING COUNCIL :—*The powers of the Supervising Council should be clearly defined and should be wide enough to include those given to the Federal Reserve Board in the Federal Reserve System of America, the difference being that the Council would have jurisdiction over the Managing Board, whereas the Federal Reserve Board has power over twelve such Boards (Vide Chapter IX).

*ADVANTAGES OF THE SCHEME :—*Even in the method of selecting the members of the Supervising Council and those of the Federal Reserve Board there would be *in essence* little constitutional difference, because in the former they would be the nominees of a Joint

Committee of the two Houses of the Central Legislature, and in the latter they are appointed by the President of the United States "by and with the *advice and consent* of the Senate." In the Federal Reserve Board, the Secretary of the Treasury and the Comptroller of Currency are *ex-Officio* members, but in the Supervising Council they would be active members and the former should be the President of the Council.

Just as the Federal Reserve Board does not directly interfere in the actual daily transactions of the Reserve Banks but appoints on each *Local Board* of the Bank three directors (that is one-third of the total number of directors of each Board) the Supervising Council should do the same and in the same proportion, with the difference that the members so selected *should be out of their own number*. But the 'canon' of non-interference by members of the Legislature or Government in the management of the Central Bank would be observed by the provision that the members so selected should neither be members of the Legislature nor officials but should be *experts* nominated by them. This method of selection of the Council and the Board would satisfy the representatives of the people that they have the power to frame the constitution of the Bank in such a way that they would indirectly control the Bank, without actually interfering in the day to day conduct of its business, and would thus feel assured that the Bank was managed in the interests of India.

It would also meet the wishes of the Indian representatives of the people, because a majority of Indian members upon the Council and on the Board would be ensured. This provision cannot be deprecated on the grounds of racial distinction because even Sir Basil Blackett had

agreed to the principle and had openly emphasized it when, during the debate on the Bill on 1st September, 1927, he said that he had "established his desire for the creation of a bank with an Indian outlook by agreeing to provide for *a majority of elected Indians* on the Directorate." The provision would also be in keeping with those of almost all Central Banks, which provide for the representation of their nationals.

Further, the various interests of the country would also be represented on the Bank either by direct appointments by the best representatives of the people or by election by their own constituents. Even the Indian Joint Stock Banks would have no cause to grumble, for, if they are compelled by Law to keep compulsory reserves with the Reserve Bank, they are given the chance to send their representatives on the Board, although he is neither to be a director nor an official of any Bank. The Supervising Council and the Managing Board are in fact, so designed that they would be in the hands of a majority of business men and representatives of all other interests, thus creating the feeling that public welfare is the sole consideration in determining the policy of the Bank.

II. FEDERAL STRUCTURE FOR RESERVE BANKING IN INDIA :—An alternative scheme is also possible. As India, like the United States, is a country of immense distances and the activities of the various parts of the country differ, it would seem wise to adopt the *modified Federal Plan*. This is all the more necessary because the transport system in India is not so well developed as in the United States and as the branches of a single unit would be separated from the Head Office by large distances, it would be difficult for the latter to control them. In splitting up India geographically into

reserve districts for instituting independent regional Reserve Banks the fundamental principle to be considered would be the *nature of the crops raised* within the district and the *seasonal demands for credit* there, because primarily regional banks would be designed to meet satisfactorily these seasonal demands. A Reserve Bank would be necessary in a region where, say, cotton or wheat was produced, or the region marked out for each Bank would be a cross section which would contain in some part of it one kind of crop, say, cotton, and in another, say, grains. Whatever the method followed in distributing the Banks, the principal consideration should be their capacity to meet the seasonal needs of agriculture and to reduce the great variations in the rates of interest during the various months of the year. This principle was very wisely followed in the United States in instituting the Reserve Banks in different regions. Indeed, regional banks would bring to the various parts of the country the many advantages which result from facility in conducting business, and in making internal payments if the cheque habit is developed. The treasury work of the Government could also be executed by the Reserve Bank more effectively within independent regions. There would be greater concentration on local needs, which would be better looked after, and increasing facilities could be given to them. It is also true that the Managing Board of an independent Bank on the spot can come to quicker decisions regarding the granting of credit by assessing an individual's or a bank's credit with greater accuracy than a mere manager of a branch could. Besides, as each Board would consist of the best local talent, the conditions could be better studied and provided for.

The essential difficulty to be faced in establishing re-

gional banks is the possibility of a particular regional bank coming to grief for want of sufficient business in case of a total or partial failure of rains within the region, for normally a considerable proportion of its business would consist of financing a great staple. But in the case of a single unit having its branches throughout the country, if there was a failure of rains in one region, resulting in financial loss to a branch, the business transacted by the Head Office and other branches would enable them to cover this loss. If this great difficulty could possibly be avoided by so dividing the regions geographically that each region is wide enough (particularly in the central parts of the country) to compensate in one part for a possible loss in another, then the Federal Plan would be better than the unitary one.

Assuming, then, that the regions are economically marked out, the structure of the Reserve Bank could be based on the Federal Reserve System of the United States with a few modifications to suit local conditions.

In the first place, there should be, as in the United States, a *Central Board*, to control and co-ordinate the activities of the Reserve Banks so as to establish a nationwide credit policy. *The method of instituting the Central Board and its constitution should be the same as suggested for the Supervising Council of a Unitary Reserve Bank (See Pages 351-355) for the reasons already stated.* The powers of the Central Board should be the same as in the United States. The Board of Directors of each Reserve Bank should consist of, say, 9 members. Out of these, 4 members including the Governor and Vice-Governor should be appointed by the Governor-General and the remaining 5 members should be appointed by the Central Board. The members so selected by

the Central Board should *not* be from its own personnel, as suggested in the case of a unitary Reserve Bank for India, but external to it and subject to the following fundamentals emphasized above :—

- (a) that the persons appointed shall be those who have been actively engaged for a particular period of time in any of the branches of Economy stated above ;
- (b) that all the 5 members so selected shall be Indians, so that a majority of Indians on the Board is obtained, and
- (c) that no member of a legislature, nor a director nor an official of a bank shall be eligible for appointment.

Such a Board, as stated previously, would meet the wishes of all sections of the people as well as the Government, and the spirit of compromise would be the basis on which the edifice of a Reserve Bank would rest.

Further, each Reserve Bank should have a special department for Rural Credits which would work under the corresponding Central Department of the Central Board. The reasons for this suggestion have already been set forth in a previous chapter.

APPENDIX

THE GOLD STANDARD AND RESERVE BANK OF INDIA BILL, 1928.

[N. B. This Bill was to have been introduced by Sir Basil Blackett, the late Finance Member, in the Legislative Assembly on 1st February 1928, but permission to do so was not granted by the President of the Legislative Assembly (see Chapter XV). However, as most of the provisions concerning the Reserve Bank (except, chiefly, the provision relating to the Constitution of the Directorate of the Bank) were already the result of the amendment on the Bill of 1927, by the Joint Select Committee of the Central Legislature, this Bill is taken as the basis for discussion in this book.]

Important Provisions of the Bill.

CHAPTER I.

Preliminary.

1. (1) *Short title, extent, commencement and duration.* This Act may be called the Gold Standard and Reserve Bank of India Act, 1928.

(2) It extends to the whole of British India, including British Baluchistan and the Sonthal Parganas.

(3) This section shall come into force at once, and the remaining provisions of this Act shall come into force on such date or dates, not later than the 1st day of July, 1929, as the Governor-General-in-Council may, by notification in the Gazette of India, appoint:

Provided that the Governor-General-in-Council may, by notification in the Gazette of India stating his reasons for such action, substitute for the year 1929 in this section the year 1930; and may, by like notifications, make two further successive substitutions of the years 1931 and 1932.

(4) Chapter III shall be in force for a period of twenty-five years and its operation may thereafter be extended for such further period or periods as the Governor-General-in-Council may, by notification in the Gazette of India, direct.

2. *Definitions.* In this Act, unless there is anything repugnant in the subject or context,—

(a) "the Bank" means the Reserve Bank of India constituted by this Act;

(b) "the Banking Department" means and includes all departments of the Bank other than the Issue Department;

(c) "bank rate" means the rate published by the Bank under section 47;

(d) "bank note" means paper money issued by the Bank;

(e) "the Board" means the Board of Directors constituted in accordance with section 9;

- (f) "general meeting" means a meeting of the registered shareholders of the Bank ;
- (g) "gold standard country" means any country, other than British India, from which any person is at liberty to export gold and in which any person may obtain gold on demand from the principal currency authority on payment of the equivalent thereof, as prescribed by law, in legal tender currency ;
- (h) "Issue Department" means that department of the Bank which is charged by section 23 with the conduct and management of the note issue ;
- (i) "provincial co-operative bank" means any society which is registered or deemed to be registered under the Co-operative Societies Act, 1912, or any other law for the time being in force in British India relating to co-operative societies and the sole business and object of which is the financing of the other societies in a province which are or are deemed to be so registered ;
- (j) "the Reserve" means the assets of the Issue Department as specified in section 31 ;
- (k) "the Reserve Fund" means the Reserve Fund referred to in section 46 ;
- (l) "rupee coin" means silver rupees which are legal tender under the provisions of the Indian Coinage Act, 1906 ; and
- (m) "scheduled bank" means a bank included in the First Schedule.

CHAPTER II.

Incorporation, Share Capital, Management and Business.

Establishment and Incorporation of the Reserve Bank of India.

3. (1) *Establishment and incorporation of Reserve Bank.* A Bank to be called the Reserve Bank of India shall be constituted for the purpose of taking over the management of the currency from the Governor-General-in-Council and of carrying on the business of banking in accordance with the provisions of this Act.

(2) The Bank shall be a body corporate by the name of the Reserve Bank of India, having perpetual succession and a common seal, and shall by the said name sue and be sued.

Share Capital.

4. (1) *Share capital, share registers and shareholders.* The original share capital of the Bank shall be five crores of rupees divided into shares of one hundred rupees each, which shall be fully paid up.

(2) No amount in excess of twenty thousand rupees shall be issued to any one person or to any two or more persons jointly, and no person shall be allowed to acquire an interest in the share capital of the Bank, whether held in his own right, or held jointly with others, or held partly in his own right and partly jointly with others, to a nominal value in excess of twenty thousand rupees.

(3) Separate registers of shareholders shall be maintained at Bombay, Calcutta, Madras, Rangoon and Delhi, and a separate issue of shares shall

be made in each of the areas served by those registers, as hereinafter defined, and shares shall not be transferable from one register to another save in accordance with conditions to be prescribed by the Governor-General-in-Council.

(4) A shareholder shall be qualified to be registered as such in any area in which he is ordinarily resident or has his principal place of business in India, but no person shall be registered as a shareholder in more than one register or as a holder of an interest in the share capital of a total nominal value exceeding twenty thousand rupees; and no person who is not—

- (a) domiciled in India, or
- (b) a British subject ordinarily resident in India, or
- (c) a company registered under the Indian Companies Act, 1913, or a society registered under the Co-operative Societies Act, 1912, or a scheduled bank, or a corporation or company incorporated by or under an Act of Parliament or any law for the time being in force in any of His Majesty's dominions and having a branch in British India,

shall be registered as a shareholder or be entitled to payment of any dividend on any share.

(5) The Board may, at its discretion, without giving any reason, decline to allot shares to any applicant or to register any transfer of shares.

(6) The areas served by the various registers mentioned in sub-section (3) shall be as follows, namely:—

- (a) by the Bombay register—the Presidency of Bombay (including Sind), and the Central Provinces;
- (b) by the Calcutta register—the Presidency of Bengal and the provinces of Bihar and Orissa and Assam;
- (c) by the Madras register—the Presidency of Madras and the province of Coorg;
- (d) by the Rangoon register—the province of Burma, and the Andaman and Nicobar Islands;
- (e) by the Delhi register—the remainder of India, including the territories of Indian Princes and Rulers in India.

(7) The nominal value of the shares originally assigned to the various registers shall be as follows, namely:—

- (a) to the Bombay register—one hundred and fifty lakhs of rupees;
- (b) to the Calcutta register—one hundred and fifty lakhs of rupees;
- (c) to the Madras register—forty lakhs of rupees;
- (d) to the Rangoon register—forty lakhs of rupees;
- (e) to the Delhi register—one hundred and twenty lakhs of rupees:

Provided that, in the event of the shares assigned to any register not being fully taken up at the first allotment, the Board may, with the previous sanction of the Governor-General-in-Council, transfer a portion of such shares from that register to another.

(8) In allotting the shares assigned to a register, the Board shall, in the first instance, allot one share to each applicant qualified under sub-section (4) to be registered as a shareholder on that register; and, if the number of such applicants is greater than the total number of shares assigned to the

register, shall determine by lot the applicants to whom the shares shall be allotted.

If the number of applicants is less than the number of shares assigned to the register, the Board shall allot the remaining shares to applicants who have applied for more shares than one; and if the number of extra shares so applied for exceeds the number of shares so to be allotted, the Board shall allot them among the various applicants in such manner as it may deem fair and equitable:

Provided that such allotments shall in all cases be subject to the restrictions contained in sub-section (2).

If, after all applications have been met in accordance with the provisions of this sub-section, any shares remain unallotted, they shall, notwithstanding anything contained in this section, be allotted to Government, and shall be sold by the Governor-General-in-Council, at not less than par, as soon as may be.

Offices and Branches.

6. *Head office, branches and agencies.* The Head Office of the Bank shall be established in Bombay, and the Bank shall, as soon as may be, establish branches in Calcutta, Madras, Rangoon, Delhi and London, and may establish branches or agencies in any other place in India or, with the previous sanction of the Governor-General-in-Council, elsewhere.

Management of the Bank.

7. *Management.* The general superintendence of the affairs and business of the Bank shall be entrusted to a Board of Directors which may exercise all powers and do all such acts and things as may be exercised or done by the Bank and are not by this Act expressly directed or required to be done by the Bank in general meeting.

8. (1) *Qualifications and disqualifications for Directorships.* Save as expressly provided in this Act—

(a) no person may be a Director who is not or has not at some time been—

(i) actively engaged in agriculture, commerce, finance or industry, or

(ii) a director of any company as defined in clause (2) of section 2 of the Indian Companies Act, 1913, or of a corporation or company incorporated by or under any law for the time being in force in any place outside British India; and

(b) no person may be a Director who is—

(i) a government official, or

(ii) an officer or employee of any bank, or

(iii) a director of any bank, other than a registered society as defined in clause (e) of section 2 of the Co-operative Societies Act, 1912.

(2) The election or appointment as Director of any person who is a member of the Indian Legislature or of a local Legislature shall be void, unless within one month of the date of his election or appointment he ceases to be such member, and if any Director is elected or nominated as member of any such Legislature he shall cease to be a Director as from the date of such election or nomination, as the case may be.

9. (1) *Composition of the Board, and term of office of Directors.* The Board shall consist of the following Directors, namely:—

- (a) a Governor and two Deputy Governors to be appointed by the Governor-General-in-Council after consideration of any recommendation made by the Board in that behalf;
- (b) four Directors to be nominated by the Governor-General-in-Council;
- (c) two Directors to be elected by the Associated Chambers of Commerce;
- (d) two Directors to be elected by the Federation of the Indian Chambers of Commerce;
- (e) one Director, representing the interests of agriculture, to be elected by provincial co-operative banks holding shares to the nominal value of not less than five thousand rupees;
- (f) eleven Directors to be elected on behalf of the shareholders on the various registers, in the manner provided in section 10 and in the following numbers, namely:—
 - (i) for the Bombay register—three Directors;
 - (ii) for the Calcutta register—three Directors;
 - (iii) for the Madras register—one Director;
 - (iv) for the Rangoon register—one Director;
 - (v) for the Delhi register—three Directors; and
- (g) one government official to be nominated by the Governor-General-in-Council.

(2) The Governor and Deputy Governors shall devote their whole time to the affairs of the Bank, and shall receive such salaries and allowances as may be determined by the Board, subject to any minimum prescribed by the Governor-General-in-Council.

(3) The Governor, a Deputy Governor and a Director nominated or elected under clause (b), (c), (d), (e), or (f) shall hold office for five years, or thereafter until his successor shall have been duly appointed, nominated or elected, and, subject to the provisions of section 8, shall be eligible for re-appointment, re-nomination or re-election, as the case may be.

The Director nominated under clause (g) shall hold office during the pleasure of the Governor-General-in-Council. He may attend any meeting of the Board and take part in its deliberations, but shall not be entitled to vote.

(4) No act or proceeding of the Board shall be questioned on the ground merely of the existence of any vacancy in, or any defect in the constitution of, the Board.

10. (1) *Election of Directors representing shareholders.* The shareholders registered on the various registers shall elect delegates for the purpose of electing Directors to represent them on the Board, and the numbers of delegates shall be as follows, namely:—

- (a) for the Bombay register—twenty-four members;
- (b) for the Calcutta register—twenty-four members;
- (c) for the Madras register—ten members;
- (d) for the Rangoon register—ten members;
- (e) for the Delhi register—twenty-four members.

(2) Every shareholder who has been registered on a register for not less

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than six months immediately preceding the election shall be entitled to vote at the election of delegates for the shareholders on that register; and no shareholder shall have more than one vote.

(3) The delegates for the shareholders on a register shall be elected from among those who are shown on that register as having held, for a period of not less than six months immediately preceding the election, unencumbered shares of the Bank of a nominal value of not less than five thousand rupees:

Provided that no person shall be elected as a delegate who is a government official or an officer or servant of the Bank:

Provided further that no candidate may stand for election, unless he has been nominated by not less than twenty of the shareholders entitled to vote at the election.

(4) The election of delegates for the shareholders on a register shall be held once in every five years, at a convenient time before the expiry of the term of office of the retiring Directors for the election of whose successors the delegates are to be elected.

(5) Delegates shall hold office for a period of five years:

Provided that, if a delegate ceases to be qualified for election under sub-section (3), he shall forthwith cease to hold office as a delegate.

(6) A casual vacancy in the office of delegate, in whatsoever manner arising, may be filled by the Board from among the shareholders for the time being qualified for election to that office under sub-section (3).

(7) The delegates for the shareholders on a register shall elect, from among those shareholders, the Directors to represent them on the Board, in accordance with this Act and the rules made under section 13.

11. (1) *Removal of Directors.* The Governor-General-in-Council may remove from office the Governor, a Deputy Governor, or any Director nominated or elected under clause (b), (c), (d), (e) or (f) of sub-section (1) of section 9, on a resolution passed by the Board in that behalf by a majority consisting of not less than fifteen Directors:

Provided that, in the case of a Director elected under clause (c), (d), (e) or (f), such resolution shall have been confirmed by a majority of not less than two-thirds of the persons present and voting at a general meeting expressly called for that purpose.

(2) A Director nominated or elected under clause (b), (c), (d), (e) or (f) of sub-section (1) of section 9 shall cease to hold office if, at any time after the expiry of one month from the date of his nomination or election or of eighteen months from the date on which this Act comes into force, whichever is later, he is not registered as a holder of unencumbered shares of the Bank of a nominal value of not less than ten thousand rupees, or if he ceases to hold unencumbered shares of that value.

15. (1) *General meetings.* A general meeting (hereinafter in this Act referred to as the annual general meeting) shall be held annually at Bombay within six weeks from the date on which the annual accounts of the Bank are closed, and a general meeting may be convened by the Board at any other time.

(2) Any shareholder shall be entitled to attend and vote at any general meet-

ing, and no shareholder, whether present in person or voting through another shareholder as proxy, shall have more than one vote.

Business of the Bank.

17. *Business which the Bank may transact.* The Bank shall be authorised to carry on and transact the several kinds of business hereinafter specified, namely :—

- (1) the accepting of money on deposit without interest from, and the collection of money for, the Secretary of State in Council, the Governor-General-in-Council, Local Governments, banks and any other persons ;
- (2) (a) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and arising out of *bona fide* commercial or trade transactions, bearing two or more good signatures, one of which shall be that of a scheduled bank, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace ;
- (b) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and bearing two or more good signatures, one of which shall be that of a scheduled bank, or a provincial co-operative bank, and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and maturing within six months from the date of such purchase or rediscount, exclusive of days of grace : provided that the total face value of bills or notes so purchased or rediscounted shall not at any time exceed one-fourth of the total face value of all bills and notes purchased or rediscounted by the Bank up to that time ;
- (c) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and bearing the signature of a scheduled bank, and issued or drawn for the purpose of holding or trading in securities of the Government of India or a Local Government, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace ;
- (3) the purchase from and sale to scheduled banks and persons approved by the Board, in amounts of not less than the equivalent of one lakh of rupees, of the currencies of such gold standard countries as may be specified in this behalf by the Governor-General-in-Council by notification in the Gazette of India, and of bills of exchange (including treasury bills) drawn in or on any place in any such country, and maturing within ninety days from the date of such purchase, exclusive of days of grace ; and the keeping of balances with banks in such countries ;
- (4) the making of loans and advances, repayable on demand or on the expiry of fixed periods not exceeding ninety days against the security of—
 - (a) stocks, funds and securities (other than immovable property) in which a trustee is authorised to invest trust money by any Act of Parliament or by any law for the time being in force in British India ;
 - (b) gold coin or bullion or documents of title to the same ;
 - (c) such bills of exchange and promissory notes as are eligible for pur-

- chase or rediscount by the Bank : provided that the total of the loans and advances against such securities as are referred to in sub-clause (b) of clause (2) shall not at any time exceed one-fourth of the total loans and advances made by the Bank up to that time ;
- (d) such bills of exchange as are eligible for purchase by the Bank under clause (3) ;
- (e) promissory notes of any scheduled bank or a provincial co-operative bank, supported by documents evidencing title to goods which have been transferred, assigned, hypothecated or pledged to any such bank as security for a cash credit granted for *bona fide* commercial, or trade transactions, or for the purpose of financing seasonal agricultural operations or the marketing of crops : provided that no loan or advance shall be made on the security of any promissory note such as is referred to in this sub-clause after the expiry of five years from the date on which this section comes into force ;
- (5) the making of advances to the Governor-General-in-Council repayable in each case not later than three months after the close of the financial year in respect of which the advance has been made ;
- (6) the issue of demand drafts and the making, issue and circulation of bank post bills made payable on its own branches ;
- (7) the purchase and sale of securities, maturing within five years from the date of such purchase, of the Government of any gold standard country specified in this behalf by the Governor-General-in-Council by notification in the Gazette of India ;
- (8) the purchase and sale of securities of the Government of India of any maturity, or of a Local Government or of a local authority in British India maturing within ten years from the date of purchase : provided that the amount of such securities held at any time in the Banking Department shall be so regulated that—
- (a) the total value of such securities shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and two-fifths of the liabilities of the Banking Department in respect of deposits ;
- (b) the value of such securities maturing after six months shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and one-fifth of the liabilities of the Banking Department in respect of deposits ;
- (c) the value of such securities maturing after one year shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and one-tenth of the liabilities of the Banking Department in respect of deposits ; and
- (d) the value of such securities maturing after ten years shall not exceed the aggregate amount of the share capital of the Bank and the Reserve Fund ;
- (9) the custody of monies, securities and other articles of value, and the collection of the proceeds, whether principal, interest or dividends, of any such securities ;

- (10) the sale and realisation of all property, whether movable or immovable, which may in any way come into the possession of the Bank in satisfaction, or part satisfaction, of any of its claims ;
- (11) the acting as agent for the Secretary of State in Council, the Governor-General-in-Council or any Local Government in the transaction of any of the following kinds of business, namely :—
- (a) the purchase and sale of gold or silver ;
 - (b) the purchase, sale, transfer and custody of bills of exchange, securities or shares in any company ;
 - (c) the collection of the proceeds, whether principal, interest or dividends, of any securities or shares ;
 - (d) the remittance of such proceeds, at the risk of the principal, by bills of exchange payable either in India or elsewhere ;
 - (e) the management of public debt ;
- (12) the purchase and sale of gold coin and bullion ;
- (13) the opening of an account with, and the acting as agent or correspondent of, any other bank which is the principal currency authority of a gold standard country under the law for the time being in force in that country or any of the Federal Reserve Banks in the United States of America ;
- (14) the borrowing of money for a period not exceeding one month for the purposes of the business of the Bank, and the giving of security for money so borrowed :

Provided that the total amount of such borrowings shall not at any time exceed the amount of the share capital of the Bank :

Provided, further, that no money shall be borrowed under this clause from any person in British India other than a scheduled bank ;

- (15) the making and issue of bank notes subject to the provisions of this Act ; and
- (16) generally, the doing of all such matters and things as may be incidental or subsidiary to the transaction of the various kinds of business hereinbefore specified.

18. *Power of direct discount.* When, in the opinion of the Board, it is necessary or expedient that action should be taken under this section in the interests of Indian trade or commerce, or for the purpose of enabling the Bank to perform any of its functions under this Act, the Bank may, notwithstanding any limitation contained in sub-clauses (a) and (b) of clause (2) of section 17, purchase, sell or discount any bills of exchange or promissory notes drawn and payable in India and arising out of *bona fide* commercial or trade transactions, bearing two or more good signatures and maturing within ninety days from the date of such purchase or discount, exclusive of days of grace.

19. *Business which the Bank may not transact.* Save as otherwise provided in sections 17, 18 and 45, the Bank may not—

- (1) engage in trade or otherwise have a direct interest in any commercial, industrial, or other undertaking, except such interest as it may in any way acquire in the course of the satisfaction of any of its claims :

provided that all such interests shall be disposed of at the earliest possible moment ;

- (2) purchase its own shares or the shares of any other bank or of any company, or grant loans upon the security of any such shares ;
- (3) advance money on mortgage of, or otherwise on the security of, immovable property or documents of title relating thereto, or become the owner of immovable property, except so far as is necessary for its own business premises and residences for its officers and servants ;
- (4) make unsecured loans or advances ;
- (5) draw or accept bills payable otherwise than on demand ;
- (6) allow interest on deposits or current accounts.

CHAPTER III.

Central Banking Functions.

Relations of the Bank with the Secretary of State in Council, the Governor-General-in-Council and Local Governments.

20. *Obligation of Bank to transact Government business.* The Bank shall undertake to accept monies for account of the Secretary of State in Council and the Governor-General-in-Council and such Local Governments as may have the custody and management of their own provincial revenues, and to make payments up to the amount standing to the credit of their accounts respectively, and to carry out their exchange, remittance and other banking operations, including the management of the public debt, on such conditions as may be agreed upon.

21. (1) *Bank to have the right to transact Government business.* The Governor-General-in-Council and such Local Governments as may have the custody and management of their own provincial revenues shall undertake to entrust the Bank, on such conditions as may be agreed upon, with all their money, remittance, exchange and banking transactions in India and elsewhere and, in particular, to deposit free of interest all their cash balances with the Bank :

Provided that nothing in this sub-section shall prevent the Governor-General-in-Council or any Local Government from carrying on money transactions at government treasuries or sub-treasuries at places where the Bank has no branches or agencies, and the Governor-General-in-Council and Local Governments may hold at such treasuries and sub-treasuries such balances as they may require.

(2) The Governor-General-in-Council and each Local Government shall undertake to entrust the Bank, on such conditions as may be agreed upon, with the management of the public debt and with the issue of any new loans.

Note Issue.

22. (1) *Right to issue bank notes.* The Bank shall have the sole right to issue paper money in British India, and may, for a period of one year from the date on which this Chapter comes into force, issue currency notes of the Government of India supplied to it by the Governor-General-in-Council, and the provisions of this Act applicable to bank notes shall, unless a contrary

intention appears, apply to all currency notes of the Government of India issued either by the Governor-General-in-Council or by the Bank in like manner as if such currency notes were bank notes, and references in this Act to bank notes shall be construed accordingly.

(2) On and from the aforesaid date the Governor-General-in-Council shall not issue any currency notes or any other kind of paper money.

23. (1) *Issue Department.* The issue of bank notes shall be conducted by the Bank in an Issue Department which shall be separated and kept wholly distinct from the Banking Department, and the assets of the Issue Department shall not be subject to any liability other than the liabilities of the Issue Department as hereinafter defined in section 32.

(2) The Issue Department shall not issue bank notes to the Banking Department or to any other person except in exchange for other bank notes or for such coin, bullion or securities as are permitted by this Act to form part of the Reserve.

24. *Denominations of notes.* Bank notes shall be of the denominational values of five rupees, ten rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees and ten thousand rupees, and of such other denominational values, if any, as may be directed by the Governor-General-in-Council.

26. (1) *Legal tender character of notes.* Subject to the provisions of subsection (2), every bank note shall be legal tender at any place in British India in payment or on account for the amount expressed therein, and shall be guaranteed by the Governor-General-in-Council.

(2) The Governor-General-in-Council may, by notification in the Gazette of India, declare that, with effect from such date as may be specified in the notification, any series of bank notes of any denomination shall cease to be legal tender save at an office or agency of the Bank.

Assets of the Issue Department.

31. (1) *The Reserve.* The Reserve shall consist of gold coin, gold bullion, gold securities, rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department as hereinafter defined.

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

Provided that the amount of gold coin and gold bullion shall not at any time be less than thirty crores of rupees in value, and shall not be less than one-fifth of the total amount of the Reserve after the end of the fifth year, or than one-quarter of the total amount of the Reserve after the end of the tenth year, from the date on which this Chapter comes into force.

(3) The remainder of the Reserve shall be held in rupee coin, Government of India rupee securities of any maturity and such bills of exchange and promissory notes drawn and payable in British India as are eligible for purchase by the Bank under sub-clause (a) or sub-clause (b) of clause (2) of section 17 or under section 18 :

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Provided that the amount held in rupee coin shall not exceed—

- (a) during the three years after the date on which this Chapter comes into force, ninety-five crores of rupees,
- (b) during the next three years, seventy-five crores of rupees,
- (c) during the next four years, sixty crores of rupees, and
- (d) fifty crores of rupees thereafter,

or one-tenth of the total amount of the Reserve, whichever amount is greater :

Provided further that the amount held in Government of India rupee securities shall not at any time exceed one-fourth of the total amount of the Reserve or fifty crores of rupees, whichever amount is less.

(4) For the purposes of this section, gold coin and gold bullion shall be valued at 8.47512 grains of fine gold per rupee, rupee coin shall be valued at its face value, and gold and rupee securities shall be valued at the market rate for the time being obtaining.

(5) Of the gold coin and gold bullion held in the Reserve, not less than seventeen-twentieths shall be held in British India, and all gold coin and gold bullion forming part of the Reserve shall be held in the custody of the Bank or its agencies :

Provided that gold belonging to the Bank which is in any other bank or in any mint or treasury or in transit may be reckoned as part of the Reserve.

(6) For the purposes of this section, the gold securities which may be held as part of the Reserve shall be securities of any of the following kinds payable in the currency of any of such gold standard countries as may be specified in this behalf by the Governor-General-in-Council by notification in the Gazette of India, namely :—

- (a) balances at the credit of the Issue Department with a bank which is the principal currency authority under the law for the time being in force of such country, or with any of the Federal Reserve Banks in the United States of America ;
- (b) bills of exchange bearing two or more good signatures and drawn on and payable at a place in any such country and having a maturity not exceeding ninety days ;
- (c) securities maturing within five years of the Government of any part of His Majesty's dominions which is a gold standard country or of any other gold standard country specified in this behalf by the Governor-General-in-Council by notification in the Gazette of India :

Provided that, for a period of two years from the date on which this Chapter comes into force,—

- (i) any of such last-mentioned securities may be securities maturing after five years, and the Bank may, at any time before the expiry of that period, dispose of such securities notwithstanding anything contained in section 17, and
- (ii) sterling securities of the Government of India may be held as part of the Reserve.

Liabilities of the Issue Department.

32. (1) *Liabilities.* The liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Govern-

ment of India and bank notes for the time being in circulation and of an initial amount of forty crores of rupees for the purpose of providing for rupee redemption, which last-mentioned amount shall be reduced by one rupee for every five rupees delivered to the Governor-General-in-Council under the provisions of section 34, and shall be increased by one rupee for every five rupees received from him under section 35.

(2) For the purposes of this section, any currency note of the Government of India or bank note which has not been presented for payment within forty years from the 1st day of April following the date of its issue shall be deemed not to be in circulation, and the value thereof shall, notwithstanding anything contained in sub-section (2) of section 23, be paid by the Issue Department to the Governor-General-in-Council or the Banking Department, as the case may be; but any such note, if subsequently presented for payment, shall be paid by the Banking Department, and any such payment in the case of a currency note of the Government of India shall be debited to the Governor-General-in-Council.

Initial Assets and Liabilities.

33. *Transfer of assets and liabilities to the Bank.* On the date on which this Chapter comes into force, the Issue Department shall take over from the Governor-General-in-Council the liability for all the currency notes of the Government of India for the time being in circulation, and the Governor-General-in-Council shall transfer to the Issue Department gold coin, gold bullion, gold securities, rupee coin and rupee securities to such aggregate amount as is equal to the total of the amount of the liability so transferred and of a sum of forty crores of rupees. The coin, bullion and securities shall be transferred in such proportion as to comply with the requirements of section 31:

Provided that the total amount of the gold coin, gold bullion and gold securities so transferred shall not be less than one-half of the whole amount transferred.

Supply of coin, and of different forms of legal tender currency.

34. *Delivery to Government of surplus rupee coin.* The Bank may deliver to the Governor-General-in-Council all rupee coin held by it in excess of the amount which the Issue Department is permitted to hold as part of the Reserve under section 31, against payment of four rupees in bank notes, gold or gold securities for every five rupees so delivered.

35. *Purchase of rupee coin.* When the amount of rupee coin for the time being held in the Reserve does not exceed twenty-five crores of rupees, or one-tenth of the total amount of the Reserve, whichever is greater, the Bank may demand delivery of rupee coin from the Governor-General-in-Council, on payment of four rupees in bank notes, gold or gold securities for every five rupees so delivered.

36. *Obligations of Government and Bank in respect of rupee coin.* The Governor-General-in-Council shall undertake not to re-issue any rupee coin delivered under section 34 nor to put into circulation any new rupees, except

through the Bank and on the Bank's demand; and the Bank shall undertake not to dispose of rupee coin otherwise than for the purposes of circulation or by delivery to the Governor-General-in-Council under that section.

37. *Obligation to supply different forms of currency.* The Bank shall issue rupee coin on demand in exchange for currency notes of the Government of India, and shall issue currency notes or bank notes on demand in exchange for coin which is legal tender under the Indian Coinage Act, 1906, and it shall, in exchange for currency notes or bank notes of five rupees or upwards, supply currency notes or bank notes of lower value or rupees or other coins which are legal tender under the Indian Coinage Act, 1906, in such quantities as may, in the opinion of the Bank, be required for circulation; and the Governor-General-in-Council shall, subject to the provisions of section 35, supply such rupees or other coins to the Bank on demand. If the Governor-General-in-Council at any time fails to discharge this duty, the Bank shall be released from its obligations to supply such coins to the public.

Obligation to sell gold and gold exchange.

38. (1) *Sale of gold.* The provisions of this section shall have effect from such date, not later than the first day of July, 1931, as the Governor-General-in-Council may, by notification in the Gazette of India, appoint:

Provided that the Governor-General-in-Council may, by notification in the Gazette of India stating his reasons for such action, substitute for the year 1931 in this section the year 1932; and may, by like notifications, make two further successive substitutions of the years 1933 and 1934.

(2) The Bank shall sell gold bullion for delivery in Bombay to any person who makes a demand in that behalf at its office at Bombay, Calcutta, Madras, Rangoon or Delhi and pays in legal tender currency the purchase price as determined under the provisions of this section:

Provided that no person shall be entitled to demand an amount of gold bullion containing less than two hundred and fifty tolas of fine gold.

(3) The price of gold bullion for delivery in Bombay shall be twenty-one rupees, three annas and ten pies per tola of fine gold with an addition representing twice the normal cost per tola of transferring gold bullion in bulk from Bombay to such place in a gold standard country as may be specified in this behalf by the Governor-General-in-Council by notification in the Gazette of India, including interest on its value during transit:

Provided that no such addition shall be made when the rate at which the currency of the country in which the place so specified is situate can be purchased in Bombay for immediate delivery at that place is such that the equivalent of the price at which the principal currency authority of that country is bound by law to give gold in exchange for currency is less than twenty-one rupees, three annas and ten pies per tola of fine gold by an amount equal to or greater than the normal cost per tola of transferring gold bullion in bulk from the specified place to Bombay, including interest on its value during transit.

(4) The Governor-General-in-Council shall, from time to time, determine in accordance with the provisions of sub-section (3) the price at which the

Bank shall sell gold bullion for delivery in Bombay, and shall notify the price so determined in the Gazette of India. Such notification shall be conclusive as between the Bank and any other person as to the price which the Bank shall be entitled to charge in respect of any sale of gold bullion.

39. (1) *Sale of gold exchange.* The Bank shall sell, to any person who makes a demand in that behalf at its office at Bombay, Calcutta, Madras, Rangoon or Delhi and pays the purchase price in legal tender currency, at a rate equivalent to twenty-one rupees, three annas and ten pies per tola of fine gold, the currency of such gold standard country as may be notified in this behalf by the Governor-General-in-Council in the Gazette of India, for immediate delivery in that country :

Provided that no person shall be entitled to demand an amount of currency of less value than that of two hundred and fifty tolas of fine gold.

(2) For the purpose of determining the equivalent rate applicable to the sale of currency under this section, twenty-one rupees, three annas and ten pies shall be deemed to be equivalent to such sum in that currency as is required to purchase one tola of fine gold in that country at the rate at which the principal currency authority of that country is bound by law to give currency in exchange for gold, after deduction therefrom of an amount representing the normal cost per tola of transferring gold bullion in bulk from Bombay to that country, including interest on its value during transit.

(3) The Governor-General-in-Council shall, from time to time, determine the equivalent rate in accordance with the provisions of sub-section (2), and shall notify the rate so determined in the Gazette of India.

Obligation to buy gold.

40. *Obligation of Bank to buy gold.* The Bank shall buy, from any person who makes a demand in that behalf at its office in Bombay, Calcutta, Madras, Rangoon or Delhi, gold bullion for delivery in Bombay at the rate of twenty-one rupees, three annas and ten pies per tola of fine gold, if such gold is tendered in the form of bars containing not less than two hundred and fifty tolas of fine gold :

Provided that the Bank shall be entitled to require such gold bullion to be melted, assayed and refined, by persons approved by the Bank, at the expense of the person tendering the bullion.

Suspension of Reserve requirements and tax on note issue.

41. (1) *Suspension of Reserve requirements.* The Bank may, with the previous sanction of the Governor-General-in-Council, for periods not exceeding thirty days in the first instance, which may, with the like sanction, be extended from time to time by periods not exceeding fifteen days, hold in the Reserve gold coin, gold bullion or gold securities of less aggregate amount than that required by sub-section (2) of section 31 and, whilst the holding is so reduced, the proviso to that sub-section shall cease to be operative.

(2) In respect of any period during which the holding of gold coin, gold bullion and gold securities is reduced under sub-section (1), the Bank shall

pay to the Governor-General-in-Council a tax upon the amount by which such holding is reduced below the minimum prescribed by sub-section (2) of section 31; such tax shall be payable at the bank rate for the time being in force, with an addition of one per cent. per annum when such holding exceeds thirty-two and a half per cent. of the total amount of the Reserve and of a further one and a half per cent. per annum in respect of every further decrease of two and a half per cent. or part of such decrease:

Provided that the tax shall not in any event be payable at a rate less than six per cent. per annum.

42. *Bank exempt from further note tax.* The Bank shall not be liable to the payment of any stamp duty under the Indian Stamp Act, 1899, in respect of bank notes issued by it.

Duration of the privilege of note issue.

43. *Powers of Government in respect of note issue and assets of the Bank in certain circumstances.* If at any time the Bank fails to comply with any provision of this Chapter or with any other provision of this Act, the Governor-General-in-Council may, by notification in the Gazette of India, declare that the Bank has forfeited the right of note issue, and shall thereupon take over the liabilities of the Issue Department, together with such portion of the assets of the Bank as is required to meet such liabilities, and thereafter the business of the Issue Department shall be carried on in the manner prescribed by this Act by such agency as the Governor-General-in-Council may determine.

Cash reserves to be maintained by banks.

44. (1) *Cash reserves of certain banks to be kept with the Bank.* Every scheduled bank shall maintain a balance with the Reserve Bank the amount of which shall at no time be less than seven and one-half per cent. of the daily average of the demand, and two and one-half per cent. of the daily average of the time liabilities of such bank in India.

(2) For the purposes of sub-section (1), the daily average of the amounts of the demand and time liabilities of each scheduled bank shall be computed in respect of each period ending on the fifteenth and on the last day of each month.

(3) Every such bank shall send to the Governor-General-in-Council and to the Bank a monthly return, signed by two responsible officers of such bank, showing—

- (a) the amounts of its demand and time liabilities respectively in India,
- (b) the total amount held in India in currency notes of the Government of India and bank notes,
- (c) the amounts held in India in rupee coin and subsidiary coin respectively,
- (d) the amounts of advances made and of bills discounted in India respectively, and
- (e) the balance held at the Bank,

at the close of the month to which the return relates.

(4) Every such return shall be sent not later than fourteen days after the

close of the month to which it relates, and shall state whether the bank has during that month maintained with the Reserve Bank the minimum balance required by sub-section (1).

(5) Any bank failing to comply with the provisions of sub-section (3) or sub-section (4) shall be liable, on application made by or on behalf of the Governor-General-in-Council to the principal Civil Court having jurisdiction in a place where an office of the bank is situated, to a penalty of one hundred rupees for each day during which the failure continues.

(6) When it appears from any such monthly return or from a report of the Board that any scheduled bank has failed to maintain the minimum balance required by sub-section (1), the Governor-General-in-Council may call for such further return, or make such inspection of the books and accounts of that bank, as may be necessary to ascertain the amount of the deficiency, if any, and the period during which it has continued; and a bank so in default shall be liable, on application made by or on behalf of the Governor-General-in-Council to the principal Civil Court having jurisdiction in a place where an office of the bank is situated, to a penalty at a rate per annum which shall be three per cent. above the bank rate on the amount of the deficiency for each day during which the default has continued, and shall be raised to five per cent. above the bank rate after the first seven days of the deficiency.

(7) The Governor-General-in-Council shall, by notification in the Gazette of India, direct the inclusion in the First Schedule of any company, not already so included, which carries on the business of banking in British India and which—

(a) is a company as defined in clause (2) of section 2 of the Indian Companies Act, 1913, or a corporation or company incorporated by or under any law in force in any place outside British India, and

(b) has a paid-up capital and reserves of an aggregate value of not less than three lakhs of rupees;

and shall, by a like notification, direct the exclusion from that Schedule of any scheduled bank the aggregate value of whose paid-up capital and reserves at any time becomes less than three lakhs of rupees, or which goes into liquidation or otherwise ceases to carry on banking business.

Agreement with the Imperial Bank of India.

45. *Agreement with the Imperial Bank.* The Bank shall enter into an agreement with the Imperial Bank of India which shall be subject to the approval of the Governor-General-in-Council, and shall be expressed to come into force on the date on which this Chapter comes into force and to remain in force for twenty-five years, and shall further contain the provisions set forth in the Second Schedule.

CHAPTER IV.

General Provisions.

Reserve Fund and allocation of Surplus.

46. *Allocation of surplus.* After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation

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funds, and such other contingencies as are usually provided for by bankers, and after payment out of the net annual profits of a cumulative dividend at the rate of five per cent. per annum on the share capital, the surplus shall be allocated as follows:—

- (a) one-half to a Reserve Fund, until such Reserve Fund is equal to one-half of the share capital, and the remaining one-half to the Governor-General-in-Council;
- (b) thereafter, until the Reserve Fund is equal to the share capital, one-tenth to the Reserve Fund, and the balance to the Governor-General-in-Council, and
- (c) when and for so long as the Reserve Fund is not less than the share capital, a portion to an additional dividend to the shareholders calculated on the scale set forth in the Third Schedule, and the balance to the Governor-General-in-Council:

Provided that, so long as the Reserve Fund is less than the share capital, not less than fifty lakhs of rupees of the surplus, or the whole of the surplus if less than that amount, shall be allocated to the Reserve Fund.

Bank rate.

47. *Publication of bank rate.* The Bank shall make public from time to time the minimum rate at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this Act.

Audit.

48. (1) *Auditors.* Not less than two auditors shall be elected and their remuneration fixed at the annual general meeting. The auditors may be shareholders, but no Director or other officer of the Bank shall be eligible during his continuance in office. Any auditor shall be eligible for re-election on quitting office.

49. *Appointment of special auditors by Government.* Without prejudice to anything contained in section 48, the Governor-General-in-Council may at any time appoint such auditors as he thinks fit to examine and report upon the accounts of the Bank.

THE FIRST SCHEDULE

[See section 2 (m).]

Schedule of Banks.

Ajodhia Bank, Fyzabad.
Allahabad Bank.
American Express Company Incorporated.
Banco Nacional Ultramarino.
Bangalore Bank.
Bank of Baroda.
Bank of Behar.
Bank of India, Bombay.
Bank of Morvi.

Bank of Mysore.
Bank of Taiwan.
Bari Doab Bank, Lahore.
Benares Bank.
Bhargava Commercial Bank.
Bhowanipore Banking Corporation, Calcutta.
Bombay Merchants' Bank, Bombay.
Byopar Sahayak Bank, Meerut.
Canara Bank.
Central Bank of India.
Chartered Bank of India, Australia and China.
Chota Nagpur Banking Association.
Coimbatore Town Bank.
Comptoir National d'Escompte de Paris.
Dawsons Bank, Pyapon.
Eastern Bank.
Equitable Eastern Banking Corporation.
Grindlay and Company.
Hongkong and Shanghai Banking Corporation.
Imperial Bank of India.
Imperial Bank of Persia.
Indian Bank.
Industrial Bank of Western India.
Jalpaiguri Banking and Trading Corporation.
Karachi Bank, Karachi.
Karnani Industrial Bank.
Lloyds Bank.
Lyallpur Bank.
Mercantile Bank of India.
Mitsui Bank.
Muffassil Bank, Gorakhpur.
Mysore Industrial Bank.
Namboodiri Bank, Pallippuram.
National Bank of India.
National City Bank of New York.
Nederlandsche Indische Handels-bank.
Nederlandsche Handel-Maatschappij.
Nedungadi Bank, Calicut.
Oudh Commercial Bank.
P. and O. Banking Corporation.
People's Bank of Northern India.
Punjab and Kashmir Bank, Rawalpindi.
Punjab and Sind Bank, Amritsar.
Punjab Co-operative Bank.
Punjab National Bank.
Shilotri Bank, Bombay.
Simla Banking and Industrial Company.

South India Bank, Tinnevely.
 Sumitomo Bank.
 Thomas Cook & Sons.
 Union Bank of India.
 U. Rai Gyaw Thoo & Co., Akyab.
 Yokohama Specie Bank.

THE SECOND SCHEDULE

(See section 45.)

Provisions to be contained in the agreement between the Reserve Bank of India and the Imperial Bank of India.

1. The Imperial Bank of India shall be the sole agent of the Reserve Bank of India at all places in British India where there is a branch of the Imperial Bank of India and no branch of the Banking Department of the Reserve Bank of India.

2. In consideration of the performance by the Imperial Bank of India on behalf of the Reserve Bank of India of the functions which the Imperial Bank of India was performing on behalf of the Governor-General-in-Council at the places referred to in Clause 1 before the coming into force of the Reserve Bank of India Act, 1928, the Reserve Bank of India shall pay to the Imperial Bank of India a commission calculated on the total of the receipts and disbursements dealt with annually on account of Government by the Imperial Bank of India on behalf of the Reserve Bank of India. Such commission shall be one-sixteenth of one per cent. on the first 250 crores of such total and one-thirty-second of one per cent. on the remainder.

3. Subject to the condition that the Imperial Bank of India shall keep open branches not less in number than those existing at the time of the coming into force of the Reserve Bank of India Act, 1928, the Reserve Bank of India shall allow the following balances to the Imperial Bank of India at the interest rates hereinafter specified, namely:—

- (a) during the first five years from that time—3 crores free of interest ;
- (b) during the next five years—2 crores free of interest and, at the option of the Imperial Bank of India, an amount not exceeding 1 crore at 2 per cent. per annum ;
- (c) during the next five years—1 crore free of interest, and, at the option of the Imperial Bank of India, an amount not exceeding 2 crores at 2 per cent. per annum ; and
- (d) during the next five years—at the option of the Imperial Bank of India, an amount not exceeding 3 crores at 2 per cent. per annum.

4. The Imperial Bank of India shall not without the approval of the Reserve Bank of India open any branch in substitution for a branch existing at the time this agreement comes into force.

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