CHAPTER I

INTRODUCTION

1.1 Prelude

The growing literature on the theory and policy of economic development has perforce recognised the critical role of capital in the process of economic development. Capital, along with other factors of production, oils the wheels of production, facilitates exchange of goods and distribution of resources between individuals and regions and thereby contribute to the widespread activities and development throughout the country. Indeed, capital becomes the life blood as well as the sine qua non of industry, commerce, trade, agriculture, small business and in fact, every scheme of the economy and society. The critical role of capital in economic development has amply been demonstrated by the astonishing progress of the developed countries.

1.2 Scarcity of Capital and Under Development

However, the developing economies are capital starved and capital shy owing to the persistent and continuous operation of the vicious circle of low productivity, low income, low savings, low capital and low investment. The agents in developing economies do not have the necessary and sufficient amount of capital to execute their economic and social activities. In other words, the proportion of own capital to total financial resources is meagre and limited, which in turn restricts the activities of these agents. Therefore, borrowing from external sources becomes an imperative and incessant
need of the agents of production in developing countries. In other words, external assistance or what is called credit assumes paramount significance in accelerating and catalysing economic and social development in the developing countries. In fact, credit becomes the raison d'etre of the economy and has become the central axis around which the whole society and economy revolve.

1.3 Agencies of Credit

In view of the growing significance of credit, several agencies of credit have come into existence, the oldest among them being the non-formal or non-institutional money-lenders. They have, no doubt, extended a great deal of assistance to the agents of production to finance their activities. Their contribution towards credit deployment, especially, to the weaker sections of the people at the time when it is required, has been rather praiseworthy. They have acted like friends and philosophers of small men in rural hinterland. However, moneylenders have become vexatious and exploitative because they used to charge exorbitant rate of interest which are unimaginable in nature sapping the whole initiative and productivity of the agents of production. Although the credit is timely, it is inadequate and exploitative in character. Therefore the government brought a number of institutions into the production scenario so that the credit needs of the economy can be adequately and sufficiently met. For example, in India, the Co-operative movement came into existence in 1904 with the sole objective of relieving the financial distress of the poor farmers and to free them from the clutches of money-lenders. Co-operative movement in India has expanded phenomenally by leaps and bounds throughout the country extending timely and adequate credit to the poor and needy. But as the Rural Credit Review Committee has aptly stated "Co-
operation has failed but it must succeed". The co-operative societies, especially, the primary agricultural societies were not able to meet the required credit needs of the farmers and they were constrained to remain in the clutches of the feudal landlords in the system who used the co-operative societies for their egoistic ends.

The first comprehensive investigation of rural credit in India pertains to 1951-52 and is known as the All India Rural Credit Survey. It was conducted by the Committee of Direction appointed by the Governor of the Reserve Bank of India (RBI). The Integrated Scheme of Rural Credit recommended by the Committee was accepted by the very wide range of interests concerned and provided the basis for the planned reorganisation of co-operative credit in association with co-operative processing, marketing and storage. In pursuance of the recommendations of this Committee, State Bank of India (SBI) was set up which extended commercial banking facilities to rural and semi-urban centres steadily. However, it was felt that the credit facilities extended by SBI was uneven in different parts of the country. A need was felt at this juncture to have a second look at the system of rural credit. The All India Rural Credit Review Committee\(^1\) was appointed by the Governor of the RBI in July 1966 to go into the entire gamut of rural credit structure, progress made in the supply of rural credit by the different agencies specified in the recommendations of the All India Rural Credit Survey Committee.

\(^1\)Venkatappiah, *Report of the All India Rural Credit Review Committee*, Reserve Bank of India, 1969, pp.1-3.
1.4 Emergence of Commercial Banks

It was during this period that the commercial banks emerged as saviours of the society from the onslaughts of money lenders, particularly, in rural areas. A bank is an institution for keeping, lending and changing of money. Banking authorities opine that the banker's business is to take the debts of other people to offer his own in exchange and thereby create money. A bank is an organisation whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for advancing to others. Therefore a bank becomes an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions like co-operatives as they cannot create credit, though they may be accepting deposits and making advances. Commercial banks perform the following functions:

a. accepting deposits.
b. advancing loans.
c. creating credit.
d. financing foreign trade.
e. rendering agency services and.
f. providing other miscellaneous services to customers.

The evolution of banking in India is as old as authoritative history. Historians opine that banking in the oldest form existed even in the vedic period. But banking in the modern sense developed only after the advent of British rule in India. Indian banking received a major impetus after independence especially in 1955 when the Imperial Bank of India was nationalised and its undertakings were taken over by the SBI. The Banking Regulation Act of 1949 provided a charter for the functioning of the commercial banks.
Historically, most of the commercial banks in India were in the hands of the private entrepreneurs and these were used for the development of big industrial and commercial ventures and social orientation of banking was conspicuous by its absence. More specifically, the commercial banks in India were directing their advances to big industrial houses, relatives of the Directors and there were inter-banking transfer of loans among various Directors of the commercial banks. Consequently, the nationally significant priority sector, consisting of agriculture, small scale industries, road and water transport operators, retail and small business, weaker sections and Scheduled castes/Scheduled tribes were not receiving their due share.

According to Kusamakara Hebbar\(^2\) though the Banking Regulation Act, 1949 had provided enough powers to the RBI to control and direct the activities of the banking industry in the economy, it failed to weed out the vulnerable units, promote the growth of a strong and efficient system, enthuse banks to go to those areas where they were needed most and prevent the concentration of offices in a few flourishing urban centres. This was mainly due to the fact that from the early stages of its origin and development, banking industry in India confined its activities to big cities and towns which promised greater scope for mobilising deposits and extending credit and for earning profit.

Although the social control of banks had directed the banks to serve the societal credit needs, especially, of the weaker section and downtrodden, the system did not change to the desired extent. The Indian commercial banks continued to direct their advances to large and medium scale industries. The sectors demanding priority attention

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such as agriculture, small scale industries and exports had not received the due attention that they deserved.

1.5 Social Control of Banks

Banks had become an urban oriented industry and bank credit was used to further the business and industrial interests of those who controlled them. This had resulted in an almost complete neglect of the banking and credit needs of the agrarian economy of the country. A large percentage of rural population of the country was thus denied both physical and financial accessibility to banks. In order to make the spread of bank credit more broad-based, put an end to misuse of credit, facilitate increased flow of credit to hitherto neglected sectors of the economy and mould the banking industry as an effective tool of economic development, social control of banks was introduced in 1968. The primary objective of the social control was to ensure that particular clients or groups of clients were not deliberately preferred in respect of distribution of credit.

National Credit Council (NCC)

was set up in 1968 with the responsibility of estimating, the demand for bank credit from different sectors of the economy, fixing priorities for grant of loans or for investment taking into account the availability of resources and needs of the priority sectors, especially agriculture, small scale industries and exports and ensuring the optimum utilization of resources by co-ordinating the lending and investment policy of commercial and co-operative banks and other

specialised institutions. Following the recommendations of NCC, the Banking Regulation Act 1949 was amended in 1969 so as to facilitate the appointment of persons with specialised knowledge or practical experience in the fields of agriculture, small scale industry, co-operation, rural economy as members of the Board of Directors of Commercial banks for appointing a professional banker as a full time chairman of each bank, with the approval of the RBI.

It was soon realised that these steps were inadequate to attain the desired result of ensuring the use of bank funds for rapid economic growth with social justice. Mere tinkering of banking system with half hearted operation were just not sufficient to meet the desired social ends of the people at the lower level. It was increasingly realised and recognized that nothing short of State ownership and management of banks in the form of nationalisation could achieve this purpose.

1.6 Nationalisation of Commercial Banks

The nationalisation of 14 big commercial banks, on 19th July 1969 each having a deposit of Rs.50 crores or more marked the culmination of this realisation and formed a milestone in the banking history of India. Six more banks, whose demand and time liabilities have exceeded Rs.200 crores each as on March 14, 1980 were nationalised on April 15, 1980. This revolution symbolized not only a change of ownership of these banks but also signified a momentous transition from traditional banking to modern banking, and from profit oriented private banking to welfare oriented social or public banking.

The economic considerations that led to the nationalisation of commercial banks in the country were to achieve national goals such as: (a) removal of concentration
of economic power and control over banks by a small number of big industrialists who contributed equity capital amounting only to a very small proportion of the total resources of the banks. (b) provision of adequate bank credit to the crucial sectors of the economy (priority sectors) and exports, (c) extension of banking facilities to the rural and other backward areas in the country and (d) provision of incentives, increasing savings and deposits, replacing the traditional system of bank management, regulating public sector investment in private sector and allocation of banks' resources according to national priorities.

These measures, hailed as the harbinger of socialism in India, aimed at accelerating economic growth with social justice. Banks have come to be considered not only mere purveyors of money but also instruments of social change. The small men of India, who constituted the Indian social chariot were neglected and marginalised by the banking system prior to this socialistic scheme. The advent of nationalisation opened new vistas for these men who received a red carpet welcome from the Indian Commercial banks. The attitudinal changes on the part of the banks were accompanied by organisational changes in the functioning of the banking system.

1.7 Lead Bank Scheme (LBS)

One of the momentous changes that deserves mention in the context of social banking is the introduction of Lead Bank Scheme (LBS)\(^4\) in 1969 under which all the districts in the Indian Union (excepting greater Bombay, Calcutta, Madras, Union Territories of Delhi, Chandigarh and Goa) were allocated to the SBI group and Public

Sector Banks (PSB) and Private Sector Banks after taking into consideration of the factors such as the resource base of the banks concerned, contiguity of districts. Though the LBS was originally conceived as a means of minimising the regional disparities in the availability of banking facilities, its scope and contents were enlarged from time to time. Since its inception there has been different stages in the development of the LBS. The emphasis in the first stage was on impressionistic surveys of the districts allotted and to identify growth centres where branches could be opened in the beginning. The first phase was thus confined to branch expansion in the lead districts.

The second stage began with the formation of District Consultative Committee (DCC) and State Level Bankers' Committee (SLBC) to sort out and find solutions to the common problems encountered by the bankers and to bring out an effective co-ordination between the banks and the government agencies involved in the implementation of the scheme. The third stage commenced with the preparation of credit plans taking the credit gaps of the districts into account. These credit plans have been prepared with the same objectives as those of the National Development Plan in which removal of unemployment and under-employment; improvement in the standard of living of the poorest and the weaker sections of the population and meeting the basic needs of the poor are important. Credit disbursements are made by different bank branches as per the direction of the Lead Bank and the allocation made in the credit plans. In the fourth stage, the emphasis was on the compilation of district level banking statistics and review of the implementation of credit plans. In the fifth and the final stage, the RBI set up a separate cell known as, Rural Planning and Credit Department (RPCD) to supervise and guide the banks in the preparation of District Credit Plans (DCP).
Though the Lead Bank had to play a vital role in the development of banking and credit deployment in the district allotted to it, it is not expected to have a monopoly of banking business in those districts. The Lead Bank has to act as a consortium leader and elicit the co-operation of other banks operating in the district in mobilising deposits, assessing and meeting the actual and potential credit needs. In addition to mitigating the regional imbalances in the availability of banking facilities and distribution of credit, the scheme is instrumental in promoting a collective effort for the economic development of a district. Considering the various constraints such as staff, financial management, the progress achieved by banks in opening branches in rural areas is quite impressive. Yet it is felt that radical improvements in the spheres of rural branch expansion programmes are necessary.

The banking sector made remarkable progress\(^5\) after nationalisation. Within a span of 29 years between 1969 and 1998, the total number of branches of Commercial banks has increased by 7.77 times, from 8262 to 64218. The most significant expansion could be seen in the case of rural branches which increased from 1833 in 1969 to 32878 in 1998 which marks an increase of 17.94 times. The population served per bank branch has decreased considerably from 64000 in 1969 to 15000 in 1998. Though there was manifold increase in expansion of branches from 1969 to 1998 in rural areas, reduction in total number of rural branches could be noticed from 1994 onwards. As against 35389 rural branches in 1993, the branches are in the order of 35329, 33004, 32995, 32918 and 32878 in 1994, 1995, 1996, 1997 and 1998 respectively. The bank deposits had increased from Rs.4646 crores in 1969 to Rs.6,05,410

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crores in March 1998 indicating an increase of 130.31 times. The credit deployment by the banks during this period increased from Rs.3599 crores to Rs.3,24,079 crores denoting an increase of 90.05 times during the same period. The per capita deposits of commercial banks increased from a mere Rs.88 in 1969 to Rs.6270 in 1998. The per capita credit of commercial banks increased from a mere Rs.68 to Rs.3356 for the same period. The Credit Deposit Ratio (CDR) which was 77.5 per cent in 1969 has come down to 53.5 per cent in 1998. The deposits of scheduled commercial banks as percentage of national income increased from 15.5 per cent in 1969 to 50.1 per cent in 1997.

These data show a transition in the outlook of banking from class banking to mass banking. The banks have moved from mere credit lending institutions to development oriented institutions. Banks have introduced a number of novel and innovative schemes like Differential Rate of Interest (DRI) scheme and have come to finance Integrated Rural Development Programme (IRDP), Self-employment Scheme for Educated Unemployed Youth (SEEUY), now rechristened as Prime Minister’s Rozgar Yojana (PMRY).

1.8 Priority Sector Lending (PSL)

Despite all these innovative measures it was increasingly complained that men in highly productive activities were not cared for by the commercial banks on the ground that the credit flow to these sectors is unviable and that the men receiving loans end up as defaulters. Loaning to these sectors was considered unprofitable eroding the liquidity of the banks. This thinking of the private banking had to be reshaped in the light of the growing demand for credit from the most significant sectors of the economy. To
overcome this situation and to promote these vulnerable sectors, the commercial banks were directed by the Government of India to give priority to this segment of the society in their lending operations. The Commercial banks, in the light of this development, evolved the scheme of Priority Sector Lending (PSL).  

The priority sector includes agriculture and allied activities and activities related to small scale industries, small business, village and cottage industries, small road and water transport operators, other small borrowers besides professional and self-employed persons. The contribution of these sectors to net domestic product, employment, regional development, exports is significant. However, the men engaged in the economic activities of these sectors are poor, downtrodden without any capacity to finance their activities. Their low income and purchasing power do not permit them to undertake viable productive activities which can contribute to their own development and to the development of Indian society. Thus, a paradoxical situation of key and critical sectors suffering without a helping hand from the commercial banks emerged in the Indian polity. The scheme of PSL tended to remove this anomaly.

Krishnaswamy, outlined the concept of the PSL in the following words: “The concept of priority sector lending is mainly intended to ensure that assistance from the banking sector flows in an increasing manner to those sectors of the economy which, though accounting for a significant proportion of the national product, have not received adequate support of institutional finance in the past”. It is the concept which was at the backdrop of the nationalisation of the top 14 commercial banks in 1969 and another six


commercial banks in 1980. Regarding PSL, the RBI issued directions to Commercial banks after constituting a working group8 under the chairmanship of Ghosh, Deputy Governor, RBI to review and redefine the role of the banks in the implementation of PSL with reference to the 20 point programme announced by the then Prime Minister Smt. Indira Gandhi in January 1982. Priority Sector Advances (PSA) should constitute 40 per cent of total aggregate bank credit and this should be achieved by March 1985. All banks have been advised to aim at ensuring a minimum of 40 per cent of additional credit every year to priority sector. Subsequent to these directions, the commercial banks involved in priority sector lending enthusiastically. For instance, the total PSL grew by 186.13 times from Rs.504 crores in 1969 to Rs.93,807 crores in March, 1997. The proportion of PSL to total lending increased from 14 per cent in 1969 to 34.8 per cent in 19979.

Although the progress made by the banks in the matter of priority sector lending is remarkable in the wake of nationalisation and other directives, there has been slowing down in this sphere in recent times especially since 1990. For one thing the bank officials were not imbued with the new objectives of banking, more specifically, towards social and development banking. For another, they were worried about the poor and unsatisfactory recovery performance of the PSL. The other reasons attributed for this slow down are due to:

a) declining CDR
b) indiscriminate loaning to achieve the target of 40 per cent and non recovery of loans.
c) inability to follow up and monitor the recovery of small loans.

9 Reserve Bank of India, op. cit., p.2.

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This new trend of decline in advances to PSL is now causing great concern with the consequent slow down and stagnation of the economy.

The introduction of financial sector reforms in the early nineties involving Commercial banks has affected and altered the flow of directed credit to the priority sector. The rationale of financial sector reforms is that the directed credit programme like PSL has given rise to more of consumption loan than of generating productive resources in the rural areas. Narasimham Committee\textsuperscript{10} has made sensational suggestions on revamping the entire financial structure of the Commercial banks for the reason that there was decline in productivity and efficiency in the banking industry. Narasimham Committee is of the opinion that directed investment and credit programmes coupled with branch expansion have ruined the productivity and efficiency of the banking industry. The adverse outcome of the directed credit programmes is the non-availability of adequate credit to the priority and other needy segments and this forces many entrepreneurs to seek loan outside the banking arena with high rate of interest.

1.9 Problem Setting

The trends in progress of commercial banking and PSL outlined above, could by and large be seen in all the States and Union Territories including the Union Territory of Pondicherry. This Territory, an erstwhile French Colony, joined the mainstream of national planning in 1954 and has achieved remarkable economic progress. One of the factors contributing to the high development of the Union Territory could be

attributed to the liberal financing of economic activities by banks. The banking sector has experienced vast progress in the last four decades. From a mere 12 bank branches on the eve of nationalisation, there are 78 bank branches intensively located in all the four regions of the Union Territory. Structurally, functionally, conceptually and habitually, the banking sector has made very rapid progress. Banks are largely involved in the PSL although in recent times the enthusiasm is waning. The PSL exerted important impact on the development of the people, society and economy of the Union Territory till recently. The major objective of this dissertation is to analyse the trends in PSL under LBS and its relationship with the economic development of the Union Territory of Pondicherry.

More specifically, the present study is confined to an analysis of the Progress of banking in the Union Territory of Pondicherry vis a vis All India. The Union Territory of Pondicherry has been taken up for this study for the reason that there is a well-knit banking network here. The population which was predominantly agrarian on the eve of merger has now been moving towards industries and service activities. Initially, commercial banks have deployed credit liberally towards the Pondicherry economy. Of late, there has been slow down in deployment of credit resulting in low CDR and low flow towards various needy sectors thereby affecting the economic development of Pondicherry. In the backdrop of this emerging scenario of banking, the thesis has formulated the following objectives.

1.10 Objectives of the Study

i. To review the progress of banking in the Union Territory of Pondicherry since its merger with the Indian Union.
ii. To assess the progress of priority sector lending under Lead Bank Scheme (LBS) in the Union Territory of Pondicherry.

iii. To analyse the relationship between CDR and PSL.

iv. To find out whether the stipulation of the RBI with respect to PSL have been fulfilled by the banking sector of Pondicherry.

v. To assess the impact of priority sector lending on the economic development of the Union Territory.

vi. To assess the effect of deceleration in PSL vis-a-vis decline in CDR and the stagnation on the economy.

vii. To offer suggestions to improve loaning under priority sector programme, consistent with faster development of the economy in the backdrop of liberalisation of economy and the recommendations of Narasimham Committee.

1.11 Hypotheses of the Study

In the light of the above objectives, the study has framed the following hypotheses to be tested in the light of empirical facts.

i. Banks have made considerable progress in the last four decades in the Union Territory of Pondicherry.

ii. There has been a considerable flow of bank credit to priority sector under LBS of the Union Territory of Pondicherry upto 1990.

iii. Banks in Pondicherry have satisfactorily complied with the stipulations of the RBI with respect to PSL till recently.
iv. There has been a relatively slow progress of advances to the priority sector in recent times.

v. Low CDR has caused decline in advances towards priority sector.

vi. There is a positive relationship between PSL and economic development of the Union Territory.

vii. Low priority sector advances was also one of the contributory factors towards slow down in Pondicherry economy.

1.12 Scope and Limitations of the Study

The study is confined to the priority sector schemes operating in the Union Territory of Pondicherry. It is limited to Pondicherry only due to paucity of time and other resources at the disposal of the researcher. It has concentrated only on the different facets of PSL and their relationship to the economic development of Pondicherry. It is a micro level study and its findings are applicable only to this limited area. The study is based on time series secondary data collected from the banks and other Government agencies. Despite the presence of a Lead Bank in the Union Territory of Pondicherry, the priority sector data are not available on a continuous basis. The data could be collected only in bits and pieces. Time series data on a continuous basis even from RBI are not available as the data by RBI for Union Territories are compiled under one single category, namely, all Union Territories. It is supplemented in a small way by the primary data collected from 250 beneficiaries under the PSL under Prime Minister’s Rozgar Yojana. This is a major limitation of the study. In interpreting the results of this study and deducing conclusions this limitation should be kept in mind.
1.13 Chapterisation of the Thesis

The Introduction to the problem of the study, objectives, hypotheses and scope of the study is provided in Chapter I.

The concepts and Review are outlined in Chapter II.

The Research Design and Methodology adopted are sketched in Chapter III.

The Profile of the Study Area is outlined in Chapter IV.

The progress of the Banking Sector in India and the Union Territory of Pondicherry is provided in Chapter V.

The LBS in the Union Territory of Pondicherry is explained in Chapter VI.

The Progress of PSL is outlined in Chapter VII.

The relationship between CDR and PSL is sketched in Chapter VIII.

The Impact of PSL on the economic development of Pondicherry is described in Chapter IX.

The Summary, Conclusion and Policy Implications are summarised in Chapter X.