CHAPTER II

BANK CREDIT AND ECONOMIC DEVELOPMENT
The post-war years have, in a majority of the countries, been associated with development. National plans for reconstruction and development have been launched, involving huge capital outlay. This urge for development was simultaneous with the gaining of freedom from colonial rule and the psychological reluctance of the people to reconcile themselves to the conditions of poverty, though the conditions for development were not favourable because of the low levels of savings and the consequent low capital formation. This task of development in the case of an under-developed country like India, does not only impose a responsibility of creating effective demand for creating employment opportunities in the short run as in the case of depression in the advanced countries, but it implies creating structural changes in the long run. Standards of development being only comparative with those of the developed countries, the prime objectives of the economic policy in an under-developed country like India become rapid development and a high rate of growth. Only then can an under-developed country increase its per capita income and thus ensure a tolerable standard of living for the masses.

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1) "If even the wealthiest countries in the world with highest per capita incomes are not content with the stability and are working for continuous growth, it is not at all surprising that in India where the standard of living is intolerably low where stability will be synonymous with stagnation, rapid development and high rate of growth become the prime objective of policy." (Fiscal and Monetary Policy) K. Jha (Governor, Reserve Bank of India) Reserve Bank of India Bulletin, January 1968, p. 33.
The already poor existing agrarian base of the economy with the consequent subsistence level of the masses and the growing adverse ratio of the population to resources due to a spectacular increase in population speaks for itself about the magnitude of the task imposed by the prime objective of the economic policy of an under-developed country like India. It calls for development efforts from every corner; the banks on their part are increasingly required to adapt their policies to the developmental requirements. Banks would have increasingly to meet the short term, and to some extent the medium term, needs of the country. It is our purpose to study the task of banks in meeting short term and medium term needs in part I and part II respectively, of this chapter.

PART I

MAGNITUDE OF CREDIT NEEDS:

Banks are traditionally the suppliers of short term credit for trading purposes. In the process of development they cannot ignore the short term credit needs of industries; hence the major shift from trade credit to industrial credit. It is no surprise to find (as will be seen in chapter VII) this major shift from trade credit to industrial short term credit in the case of Indian banks. The limits of credit requirements cannot be fixed at any time, much less for the coming years, but the magnitude of such needs can be appreciated in the general economic situation of a country. Accordingly, it can be assumed safely that the banks in India would have to meet the increased short term credit needs for the following reasons:
In the first place, during the last three five-year plans, an industrial base has been established. Banks have accordingly shifted a major portion of credit to the industrial sector, though they have also been contributing increasingly to the growing trading sector. This expansion phase is more than temporary or seasonal as in the trading or business sector, with the gradual release of trained technologists, the urge for industrialization will only increase making more demands for bank credit. In the second place, the huge capital investment of Government during the past seventeen years in transport and other projects and thus laying infra-structure for growth by creating external economies, has also eased the path of industrialization for the country, thus only creating increased demand for bank credit. In the third place, the specialized agencies for meeting the long-term credit needs of the industries created over the years with the help of the Reserve Bank have also to play their part in the industrialization of the country. Their help in meeting the long-term needs of the industries will add to the demand for short and medium term credit of banks. In the fourth place, the banks have to meet the credit needs of priority sectors. Their field of activity has been vastly extended from the traditional sector to the industrial (including the small-scale industries) and agricultural sectors. The refinancing facilities provided by the Agricultural Refinance Corporation to the banks have been provided to induce the banks to meet the needs of agricultural sector also, though stress is primarily laid on the cooperative structure for this sector.
The recent nationalization of banks is a sufficient indication that the banks will be required to play their part in this 'neglected sector' also.

In fact, if the past is any guide, bank credit needs will only go on increasing in the process of development. The credit deposit ratio of the scheduled banks has increased from 69.1% to 78.6% from 1960-61 to 1966-67, in spite of a tremendous rise in the deposits over these years. This is clear from Table I.

MEANS FOR SATISFYING CREDIT NEEDS:-

The capacity of banks to meet the increasing credit requirements depends mainly upon their deposit base. The more the deposits the banks can mobilise, the greater their capacity to meet the credit needs of the country. Thus it is mainly through the increase in deposits that Indian banks were able to increase their credit in the post-war years. However, it cannot be said that the credit requirements have been met adequately. In fact, there is likely to be credit shortage in relation to its demand in the boom phase, which in an underdeveloped country is likely to be long-run due to the task of development. What, however, is to be noted here is the fact that the deposit expansion of the banks in recent years was greatly facilitated by the tremendous currency supply owing to the government's continued deficit financing over the last three plans.
This is clear from the table below:

<table>
<thead>
<tr>
<th>Last Friday financial year</th>
<th>Variation in currency supply with the public</th>
<th>Aggregate deposits</th>
<th>Bank credit</th>
<th>Bank credit as percentage of aggregate deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-51</td>
<td>+ 31.72</td>
<td>280.61</td>
<td>546.93</td>
<td>62.1</td>
</tr>
<tr>
<td>1955-56</td>
<td>+ 193.89</td>
<td>1043.15</td>
<td>761.25</td>
<td>73.0</td>
</tr>
<tr>
<td>1960-61</td>
<td>+ 167.19</td>
<td>1746.06</td>
<td>1319.54</td>
<td>75.6</td>
</tr>
<tr>
<td>1961-62</td>
<td>+ 103.11</td>
<td>1921.87</td>
<td>1407.61</td>
<td>73.2</td>
</tr>
<tr>
<td>1962-63</td>
<td>+ 178.31</td>
<td>2042.26</td>
<td>1586.01</td>
<td>77.3</td>
</tr>
<tr>
<td>1963-64</td>
<td>+ 226.09</td>
<td>2285.10</td>
<td>1316.46</td>
<td>79.5</td>
</tr>
<tr>
<td>1964-65</td>
<td>+ 163.49</td>
<td>2533.30</td>
<td>2033.70</td>
<td>78.7</td>
</tr>
<tr>
<td>1965-66</td>
<td>+ 265.52</td>
<td>2949.83</td>
<td>2288.14</td>
<td>77.6</td>
</tr>
<tr>
<td>1966-67</td>
<td>+ 160.60</td>
<td>3424.72</td>
<td>2692.47</td>
<td>78.6</td>
</tr>
<tr>
<td>1967-68</td>
<td>+ 177.87</td>
<td>3856.84</td>
<td>3031.90</td>
<td>78.6</td>
</tr>
</tbody>
</table>

* Provisional


Even with the continued increase in aggregate deposits, it could not proportionately meet the credit requirements. Credit deposit ratio increased from 62.1% to 73.6% along with the increase in deposits, showing that the increase in deposits did not keep pace with the increase in bank credit. Increased recourse to note issue by the government as a measure of fiscal policy has expectedly affected the banking deposit structure. But this resort to note issuing machine has its limits. This is because of its inflationary impact. "In the initial stages of economic development welfare conditions may be subordinate to the requirements of rapid growth, but basic disregard of equity as in the case of inflationary effects on the relative position of lower-income classes is likely to jeopardize the
success of overall development policy." In fact, it is
Realised that there should not be continued resort to currency
supply arising out of deficit financing. The Finance Minister,
while again presenting a deficit budget for the financial year
1968-69, called it not a pleasant matter.

1) "JOHN R. FRASER, Monetary Equilibrium and Economic Policy
(Princeton University Press, 1965) p. 10

2) "The situation indeed demands that deficit financing by
governments should be cut down if not perhaps altogether
eliminated for some years ahead, as the capacity of the
economy to bear deficit financing has been weakened by
continuous recourse to this course of finance and additional
uses of deficit financing in the light of tight position
on the supply side would be fraught with further deleterious
consequences." Monetary Policy and Economic Development,
(p. C. Bhattacharyya, Governor Reserve Bank of India)

3) "In my budget speech last year, I had referred to the need
to avoid deficit financing in the circumstances then
prevailing in the country. These circumstances have changed
for the better, but unfortunately not my budgetary
fortunes so far. In actual practice, the current year is
expected to end with a large deficit of Rs. 300 crores
at the centre. Honourable members would appreciate that it
is neither an easy nor a pleasant matter for me to come
to this House with this particular piece of information.
Speech of Finance Minister in Lok Sabha on 29th February,
1969, p. 5."
It is clear, thus, that owing to the inflationary impact of deficit financing, it cannot be accepted as a continued process. This itself speaks for the task of banks in expanding deposits without a spectacular currency supply. The coming years would naturally call for a very hectic activity for the banks. On the one hand, the growing credit needs of the country would make heavy demands on the banks; on the other hand, the means to satisfy these demands would not be easy to accumulate. Banks can also create credit by their credit-creation device (multiplier effect), but this process is greatly checked by great preference for currency by the public in this and other under-developed countries. It is here, i.e., in creating this multiplier effect of reducing the dependence on and preference for currency and greater use of deposit money for transactions by the public, that the banks would be able to meet the requirements of credit in future. This calls for more strenuous efforts on the part of banks to create saving habits by continued educative advertising, mopping the savings over a wider area than hitherto by extension of services and meeting all sectors of people, big or small. In short, there must be great concern for voluntary savings in future.

There is no doubt that in the present set-up the central bank in this and other under-developed countries is supposed to adopt a promotional role and to provide adequate liquidity to enable the banks to meet the credit needs. Accordingly, the Reserve Bank has taken keen interest in helping the banks by providing accommodation.
As will be seen in the next chapter, there serve Bank's advances to the scheduled banks have been mounting in recent years, but the central bank's assistance to the banks can only be short-term and marginal and generally towards priority sectors; otherwise it will have an inflationary impact.

PART II

Bank credit is usually of two kinds: short-term, and long-term. One more term has been added in between in recent discussions, and that with great significance. Though there is no hard and fast line of demarcation between these terms, yet some artificial division into 'upto one year', 'one year to seven years' and 'seven to twenty-five years' clears the point. Traditionally, banks are the suppliers of short-term credit because of the extreme importance of liquidity based on self-liquidity theory, but this approach of banks cannot stand, because in the process of development they are also required to meet the medium-term needs of the country, if not the long-term needs.

The orthodox theory of banking mainly centred round the concept of self-liquidity. The English banking system, from which originated the orthodox theory, developed in an era of laissez-faire. Individual initiative had few checks. Banks were thought of as competing institutions and every bank had the sole responsibility of its functioning. Banks were, therefore, required to be ready at every moment to meet their liabilities. According to the adherents of this theory,
individual banks, in order to stand on their own legs, were required to maintain very liquid assets. Such assets could be found in foreign as well as in domestic trade. This is due to the fact that the financing of goods in one of the steps from producer to consumer resulted in automatic liquidation at maturity. Two basic assumptions underlying the theory are:

1) Demand nature of liabilities and consequent sudden withdrawals; and
2) Complete individualism of the bank to meet the liabilities from out of its funds at any and everytime.

The first assumption is contradictory to the very banking principle viz., that the more the depositors, the less the possibility of sudden withdrawals; and as the size of a bank increases through an increase in the deposits, this assumption of self-liquidity theory loses its potency. The changes in the structure of deposits and more appropriation of time and savings deposits as in the recent years make the assumption still weaker, because the very nature of time element in these deposits does not lead to the possibility of sudden withdrawals of deposits. The second assumption, no doubt, holds good even today in so far as the meeting of liabilities is the primary responsibility of a bank itself, but this concept has also lost its potency with the evolution of the shiftability theory.

The shiftability theory is not different from the self-liquidity theory in so far as both these theories underline the importance of meeting depositors' liabilities. But, whereas the former provides for liquidity through the marketability of long-term papers, the latter merely insists
on short maturities. Today the problem of liquidity is not the problem of maturing loans, but that of the marketability of long-term papers. In fact, it is widely recognized that adherence to short maturities is useless, when liabilities can be met by shifting or by the sale of long-term financial papers.

The incompatibility of the orthodox theory is further exposed under the concept of rapid economic development under a different set of conditions from that of the British. Under the stress of quick economic development on the one hand and scarcity of capital markets and specialized agencies for long-term capital on the other, banks are under stronger pressure to lend on easy terms to meet the credit needs not only for facilities of trade but for the exploitation of capital resources. But more pressures for relaxing the lending terms would place the whole banking system in great jeopardy unless the basic principle of liquidity is assured. It is true that liquidity itself has become a matter of degree and a big bank may be in a position to allocate a portion of its funds for longer maturities, but the sensitiveness of the whole banking system puts the big bank also in difficulties. A failure of a small bank may lead to a run even on a big bank, thereby putting the liquidity of this bank to the test; and under the policy of catering also to the longer maturities the bank cannot stand the test, unless it can ensure the liquidity either through sale or shifting of its long-term assets.
This process of shiftability can be perfected by the central banks of the respective countries either by itself allowing refinance facilities against long-term papers directly, or through agencies created or managed by them. The central bank’s assuring the liquidity has an advantage because the central bank commands confidence both with the public and the banks. Under the circumstances, where it is possible for banks, because of their sound financial position, good proportion of their time-liabilities relative to demand liabilities, to cater to long-term needs of industries, the central bank by refinancing and thus ensuring liquidity, has only to lend confidence to the new practice. In fact, it has to save the banks against the threat of insolvency rather than insolvency itself. This process of ensuring liquidity in an emergency by the federal reserve banks in the United States unquestionably gave some impetus to the granting of long-term bank credits.

In the early stages of their economic development, advanced countries were not without problems. It would be interesting to study the role of banks towards the solution of these problems. True, the problems are to be solved in the light of the prevailing conditions and as the conditions in different countries are not the same, the role of banks in advanced countries in solving the problems of development in the earlier stages may not necessarily be a guide to the banks in the under-developed countries. Nonetheless, the experience thus available may be helpful to the under-developed countries.

Broadly speaking, banking participation in economic development has taken two routes. British banks limited their operations to short-term industrial credit only, while American and European continental countries banks played an active part in providing medium and long-term credit also. Economic development in Britain provides the first example of development. An examination of this development reveals the fact of its gradualness; it also shows that it is not applicable under contemporary conditions, because Britain had no competition to face; whereas competition, particularly in economic activity, is the order of the day now. Since the development in Britain was gradual, the necessary funds for extension were found by owners of capital comparatively easily.

Another characteristic of British economic development was that it had the background of two centuries of great progress in commerce and trade. The great growth of commerce in the seventeenth and early nineteenth centuries had produced a substantial number of prosperous merchants with capacity of investment. Besides, there existed such institutions, as London capital market, financial companies and issuing houses. These institutions supplied capital which could not be secured from the reinvestment of profits and the savings of merchants and entrepreneurs. In short, when British joint stock banks began to develop in the middle of the last century, they found the financial mechanism well adapted to the needs of the industry. The machinery for promotion, underwriting and issuing was already functioning with reasonable efficiency. Long-term capital for joint stock enterprise was readily obtainable and the rapidly developing banks found their most profitable avenue of operation in the business of short-term banking.

That is more remarkable, is that the British banks never felt the paucity of outlet for short-term credit. With increase in the foreign exchange business London became the world financial centre and the British banks got more and more opportunities of practising this business. Other countries of Europe and America did not have such favourable circumstances. Having started economic development at a later stage, they had to catch up with the economic progress of the United Kingdom. In their efforts to accelerate the state of progress,
they had to allocate large amounts for industrial development and other purposes. Techniques and machinery had to be imported involving heavy expenditure. Unlike the United Kingdom, where with the great progress of commerce before the Industrial Revolution, external economies like transport had fully developed, these countries had innumerable difficulties to face; therefore, side by side with other investments, these countries had to invest large amounts in providing adequate transport facilities. Again, in the United Kingdom, agricultural improvements had long preceded the industrial revolution, but in the continental countries and the United States, agriculture was in a backward position. Hence both these sectors had to be developed simultaneously in order to achieve quick economic development.

As already pointed out, these countries, lacking the background of commercial and agricultural development, had a weaker financial position than that of the United Kingdom. There was neither the accumulation of capital from improved agriculture or commerce, nor were there specialized institutions like the under-writing, issuing or other financial houses. In this disadvantageous situation, the banking practices had to be adapted to the requirements of these countries. Thus in America “banks in general were under stronger pressures to lend on easy terms then to meet their obligations. They were run for borrowers who were tortured with a thirst for credit; and the credit was sought
not for the facilities of trade but for the exploitation of
capital resources." Similarly, German banks, owing to the
pressure of circumstances, began to take part in the management
and control of industries. About the middle of the nineteenth
century, Germany was a comparatively, poor country. The
great demand for capital for her rapidly growing industries,
lead, naturally, to the development of banks, which took a
large and active part in providing the capital for the
creation and extension of business undertakings. This was
done both by the grant of long-term loans and by the
floaation of joint stock companies. Thus German banks went
a step further than American banks. The latter simply confined
their practices to simple investment banking while the former
went ahead also in the management and control of banks.

Similarly were the circumstances in Belgium. At the beginning
of her industrialization, there was scarcity of investors in
this country. Industrial concerns were, therefore, obliged to
rely extensively on the then existing banking facilities. The
leaders of the Belgian banks simply disregarded the teachings
of econonists, their need being to develop an industrial base,
they strived hard to finance their industries.

In short, it was not the deliberate attempt of banks in
any country to participate or not to participate in long-term
industrial credit. Circumstances favoured one or the other practice.

1) CRUSCOTT, PAUL R., Financing American Enterprise, (New York,
2) CRUSCOTT, P. R., Belgian Banking and Banking Theory,
42

Even in the United Kingdom, with the changed circumstances, especially after the First World War, banks could not strictly adhere to their old practices.

ECONOMIC DEVELOPMENT OF
UNDER-DEVELOPED COUNTRY—INDIA—

What was true of the majority of the European continental countries and the United States, is also true of India as well as of the most of the other under-developed countries today. The position of the latter is even worse than that of the former.

Economic development in an under-developed country like India basically means an increase in the living standards of large and rapidly growing population, with limited resources. The most obvious difference between the contemporary and the past setting of economic development problem is that the present under-developed countries appear to have a less favourable ratio of population to resources than did Western Europe, the British Dominions and the United States in the nineteenth century. It necessitates an all-round economic development with great stress on quick industrialization. It necessitates the employment of the latest types of machines, which in turn involves higher capital outlay.

Financially also, the position of the under-developed countries is worse than that of advanced countries in the initial stages of their economic development.

The level of incomes is too low to warrant substantial amounts of savings. Unlike in the United Kingdom, capital in India is shy and there is the absence of industrial pioneers like those present in the early development of England.

In spite of the fact that the problems of economic development in India are as serious as, or perhaps even more serious than, those of continental countries and the United States, Indian banks have only recently (i.e., after the establishment of Refinance Corporation for Industry in 1958) recognised the systematic participation in medium-term needs of the industries, though meeting the medium-term needs of industries through frequent renewals of short-term loans and holding some less liquid assets was practised by Indian banks like their British counterparts. The response of the Indian banks in this respect was delayed for the following reasons:

In the first place, the Indian banks had learnt lessons from the previous attempts of long-term industrial financing, i.e., Swadeshi Movement and the World War I. During the Swadeshi Movement (1906-1913), the people's bank, a typical example of the failure of this period, like the Amritsar Bank, granted a loan of Rs. 15 lakhs to the Upper India Real Estate Company which speculated in land. Similarly, the Hindustan Bank advanced large amounts to the Punjab Musical Association (a theatre without capital) and to the Hindustan Brothers' Company - (a speculative shop at Karachi). The Industrial Bank lent considerable sums to its chief promoter and his concerns. The Lahore Bank advanced large sums to one of its directors and its chief manager.
It had also a large investment in a leather factory in which its promoters were interested. Similarly, Noaba Bank made advances to Amritsar general and flour mills and to the Whegora mills in Fapurthala State. In both of these its directors had interests.

Similarly, during the years following the World War I, the State Industrial Bank, the chief ventures of this period, came to the grief because its investments were neither carefully planned nor wisely selected. From the causes of failures of the banks in these two distinct periods, when attempts were made for long-term industrial financing, it is clear that there was nothing wrong with the industrial financing as such; rather the methods of processing these loans were either imperfect or even fraudulent. This was especially so at a time, when there was no central bank or any supervising authority to check fraudulent intentions or specify limits to such financing. Nor was there any comprehensive banking legislation to prohibit such loans to directors, chief managers and promoters. In fact, it was rightly what a writer of that time called "the ease of an army going to the battle without any trained officers and without any orders from the general staff."

Nevertheless, Indian depositors were witnesses to the spectacular fall of one bank after another. For bankers the renewal of such a task (medium-or long-term lending) in the post-war years meant very careful processing and supervision; for Indian depositors it meant a confidence in bank management; and even for the central bank, it meant an effective check and supervision.

In the second place, the post-war years witnessed the spectacular development of specialized financing agencies for long-term industrial needs in most countries of the world, though with varied forms and structures; with a range of varied methods of operation and with no uniform responsibilities in the economic programming of their respective countries.

Accordingly, the governments of a large number of under-developed countries, aspiring for rapid economic development, either established such institutions or helped in promoting such organizations. To some extent, the establishment of these specialized agencies was helped by the World Bank; but generally promotion of such agencies was helped by the governments and the central banks of the respective countries. These establishments were promoted under the belief (gained from the experience of advanced countries from 1920's) that these specialized institutions play a very important part in economic development.

1) For details see:- P. K., Theory And Practice of Development Banking (Bombay, Asia Publishing House, 1966).

2) ibid., pp. 11 to 16.
In India also the chain was started with the establishment of the Industrial Finance Corporation of India in 1948. This was followed by the establishment of state financial corporations in almost all the states. In 1955, Industrial Credit and Investment Corporation of India was established, followed by the establishment of the Refinance Corporation for Industry Pvt. Ltd., in 1958 (now merged with the Industrial Development Bank), and lastly by the establishment of the Industrial Development Bank in 1964. Banks were part subscribers to the equity capitals of all these specialized agencies, except the last one. The establishment of these specialized institutions lessened the pressure on banks for long-term lending, though the capacity of the banks for long-term lending was recognized simultaneously.

1) Speaking on the Industrial Finance Corporation of India Bill on 10th February 1948, Prof. M. T. Shah observed:

"A glance of the financial columns of any paper on a Thursday or Friday would suffice to tell you what large deposits remain in the scheduled banks, cash credit, call money. Even if that may not be suitable for utilisation for corporation like this; even if that may not be utilisable for the long range credits in which this corporation is intended to specialise, there are something like 200 to 300 crores in fixed deposits in these institutions. Those remain idle because there are not sufficient industries, sufficiently profitable field for investment in which these funds can be utilised, employed or invested. It would be the function of the present government, when they are freed from the present preoccupations to prepare and carry out a truly national policy for allround national development in every sphere of our national life and economy, where all this money, which is lying idle, unused or unemployed would be very fruitfully and productively employed." (Constituent Assembly of India Debates, Official Report Vo. 1), R. 558.
In the third place, the second world war years had witnessed a banking boom and a number of mushroom banks were established which indulged in unsound practices. In the post-war years, which also synchronized with the starting of planned development in this country, the Reserve Bank of India, which assumed greater responsibility of stabilising banking position, devoted most of its energies to detailed and successive inspections of the banking concerns to acquaint itself with their problems. Thus the first preoccupation of the Reserve Bank after the war was to see that the public has confidence in the banking system. According to the Reserve Bank authorities, "any development of term-financing at that stage would have been risky, especially as the Bank had neither adequate resources nor the administrative machinery for such financing on a sound basis."


In the fourth place, the banks themselves resisted the pressures (which usually are exerted under the stress of economic development) of systematic participation in term-lending, until their liquidity could be assured by the central bank. This speaks for the maturity of Indian bankers, who had the earlier experience of the Swadeshi Movement and the Post World War (I) years, when such liquidity was assured with the establishment of the Refinance Corporation for Industry Pvt. Ltd., in 1958, the Indian banks showed enthusiasm for term-lending to industry.

**Refinance facilities for medium term loans:**

Refinance facilities for term loans were provided for the first time by the Refinance Corporation for Industry Pvt. Ltd. This corporation, registered under the Companies Act, 1956, was set up on 5th June, 1958. The initial capital of Rs.15.5 crores was contributed by the Reserve Bank (Rs.5 crores), State Bank of India (Rs.2.5 crores), Life Insurance Corporation of India (Rs.2.50 crores) and 14 larger scheduled banks (Rs.2.70 crores).

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1) To illustrate, **Indian Banks Association in the memorandum to the Croff Committee stated:**

"The Reserve Bank should lend readily against documents created in connection with medium term and long-term advances made by banks to industrial concerns against the latter's fixed assets........ The Reserve Bank should lend readily against the investment of banks in the debentures of industrial concerns." Committee on Finance for Private Sector, 1954, p. 47.

2) **Reserve Bank of India (Functions and Working)** (Reserve Bank of India, 1963) pp. 102-103.
simultaneously, the government of India agreed to place with the corporation a sum of Rs. 96 crores (as interest-bearing loan for 40 years) out of American Economic Assistance Public Law 480 to the aid of medium scale industry for medium term through the banking system. Thus the corporation had total resources of Rs. 38.8 crores which it could use in providing relending facilities against medium-term loans granted by member banks to medium-sized units in the private sector, primarily in industries included in the five-year plans. Loans eligible for refinance were to be of the term of between 3 and 7 years and for medium-sized amounts so that the maximum amount of loan to any one borrower did not exceed Rs. 50 lakhs. This ceiling was raised later. In the beginning the relending facility was restricted to a few banks only, but subsequently it was extended to a large number of banks, state financial corporations and state cooperative banks. At the end of 1961, 57 scheduled banks, 15 state financial corporations and 3 state cooperative banks were eligible for these refinancing facilities. It was further extended to other scheduled banks approved from time to time. Till the end of 1963, the corporation disbursed refinance of an amount of Rs. 2916.83 lakhs to the financial institutions.

In fact, it was this corporation which induced banks to venture in term loans to industry. The corporation was merged with the Industrial Development Bank of India on 1st September, 1964.

The Industrial Development Bank of India was established on 1st July, 1964, as an apex institution for industrial finance for refinancing the institutions already in the field and also for providing direct financial assistance and for filling the gaps in the country's industrial structure. A wholly-owned subsidiary of the Reserve Bank, the Industrial Development Bank has been endowed with adequate resources, potential and operational flexibility. Thus the Bank has an authorized capital of Rs. 60 crores which may be raised to Rs. 100 crores with the prior approval of the central government. Initially, it had issued capital of Rs. 10 crores subscribed by the Reserve Bank of India with the provision that it may be increased with the prior approval of the Government. Besides, there is the provision of interest-free loans from the Government, issue of bonds and debentures and deposits from the public. It is managed by the Board of Directors of the Reserve Bank of India and the Governor and a Deputy Governor are its Chairman and Vice Chairman respectively. Its direct assistance to industry takes the form of loans, guarantees of loans and deferred payments, underwriting of issues of shares and bonds and subscription to equity capital either on its own or in participation with other institutions. Its refinancing facilities in respect of loans to industrial concerns are

available to specified financial institutions, i.e. commercial banks, state cooperative banks, Industrial Finance Corporation of India, state financial corporations, Industrial Credit and Investment Corporation of India and any other financial institution that may be notified by the central government under Section 9 of the Industrial Development Bank of India Act, 1964.

Thus, it is clear that the Development Bank has a wide range of functions. We are not concerned here with these detailed functions of the Bank, but only with the refinancing facilities for medium-term loans provided to the banks. This relending facility was first assured by the Refinance Corporation in 1958 and later by the Industrial Development Bank; thus banks were induced to venture in term-loans to industry. At the end of 1967, the total outstanding for refinance disbursed to scheduled commercial banks was Rs. 52.62 crores and commercial banks had extended medium term loans to the extent of Rs. 226 crores.

**CAPACITY OF BANKS FOR TERM LENDING:**

Banks must have their own capacity to venture into term lending and must not have to depend solely upon refinancing facility; otherwise, they would only be playing the role of intermediaries between the Industrial Development Bank and the industries. The capacity of banks for rendering long-term help was examined by the Shroff Committee. According to this committee, the banks capacity is clear from the four existing facilities: (i) A part of the advances of commercial banks to the working capital is allowed to be renewed from time to time. By this device, a part of these advances, which are

1) **Trend and Progress of Banking in India, 1967.**
given for working capital, operates to release the borrowers' funds for long-term expenditure. (ii) Besides the frequent renewals of advances, banks directly purchase the shares and debentures of industrial concerns. (iii) Banks also give advances against these shares and debentures. (iv) Another advance of Indian banks in this respect is the investment in the shares and bonds of the Industrial Finance Corporation of India and state financial corporations. After the publication of the Crook Commission report, banks have also contributed to the capital of the Industrial Credit and Investment Corporation of India, central and state warehousing corporations and the Refinance Corporation of India (now merged with the Industrial Development Bank).

The renewals of short-term loans or holding of less liquid assets by banks is common in almost all countries, including those which were originally the strict adherents of the self-liquidity theory. This is because of the fact that the liquidity which a banker must maintain is a matter of degree. There can be no absolute rule in this regard forbidding the holding of medium-term and long-term assets. Almost every banker of strength and reputation does, in fact, hold some of these assets.

The capacity of banks for rendering medium-term assistance to industries has increased with (i) the great increase in deposits and (ii) the comparatively great increase in time deposits relative to demand deposits in the post-war years.

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As will be seen in chapter VI, the increase in deposits in recent years has mostly been appropriated by time-deposits in this country. This is also true of other under-developed countries. The size of a bank and the structure of its deposits has got a great bearing on its medium-term lending capacity, but simultaneously their liquidity is to be assured through refinancing of term-loans. This has been done now, and the Indian banks, which have recently ventured into the field, should acquire more of this business in the interests of the country.

COORDINATED APPROACH FOR REGIONAL DEVELOPMENT:

In the post-war years, specialized institutions for refinancing long-term industrial needs have taken a strong hold. No doubt, these institutions have great importance in the under-developed country because of the shortage of well-developed capital markets, under-writing houses, etc., but they are not a complete solution to the vast and growing capital needs of the under-developed country. It is because of this that some role was also envisaged for banks in the long-term needs of industries and their liquidity was assured through refinancing of term-loans. In fact, it is a complementary role in so far as the banks are required to venture only medium-term loans (3 to 7 years), and long-term loans (7 to 25 years) are left to specialized agencies. Given the capital and deposit capacity of banks for this task, they have an advantage over specialized agencies, through the net work

of branches and the close relation with industries through the supply of working capital, but lending for too long maturities is outside the scope of banking. This is because such lending needs proper assessment of earning capacity and managerial competence for long periods. It calls for a long view of markets, both for raw materials and for products, of the technical possibilities and labour supplies. Assessment of all these factors can be reasonably undertaken only by a large group of specialists, each one specializing in our or a few industries. The traditional bank manager is not, therefore, qualified for the industrial consultant's work. It was because of these comparative advantages of banks and the specialized financing long-term agencies, that the experts of the International Monetary Fund envisaged a complementary role for Indian banks and the specialized institutions, what it lacked until recently, was a coordinating agency. This role, has, however, now been undertaken by the Industrial Development Bank of India. This Bank, as already stated, will not only directly finance industries but will provide refinancing facilities to all institutions venturing in the industrial lending and will coordinate the activities of the existing agencies.

What, however, must be very important for the Industrial Development Bank is to coordinate the activities of the banks

and the industrial finance corporations so as to promote regional industrial development as far as possible, and secure allround development of the country. The diffused character of banking through a net-work of branches, the decentralized character of state financial corporations and the centralized character of other agencies for long term lending, should prove very helpful in regional development of industries.

**CONCLUSION:**

With the process of development the banks would be required to meet the increased credit needs. The capacity of banks for this task depends upon the deposit base. In the past banks could meet the increasing credit needs from a phenomenal increase in deposits, which in turn was facilitated by deficit financing. Now, it is realized that the increased resort to deficit financing would only distort the process of development; therefore, the extent of deficit financing is only to be lowered in the future. This poses a great challenge to banks to mobilise voluntary savings from far and near, rich or low. Only then would the banks be able to meet the growing credit needs of the country.

The development phase of an economy exerts pressures on the banks for long-term credit needs. This was also the case with the Indian banks, but the banks did not recognize the systematic participation in medium-term lending for various reasons. Even the Reserve Bank did not encourage them for the
Reason that the banking system had to be consolidated and made sound before the banks could venture in medium-term lending. When, however, the liquidity for term loans was ensured, the banks started medium-term loans. In term lending to industries there are specialized agencies and banks. Their roles are only complementary. Thus there is the necessity of coordination between the activities of these agencies for industrial lending. The recently established Industrial Development Bank of India is charged with the task of this coordination. What, however, is important, is that this coordination should be aimed at regional development of industries as far as possible, so that there is overall development of the economy.