CHAPTER - I

INTRODUCTION

Monetary policy implies an exercise of control over the availability, cost and the use of money and bank credit by means of certain monetary instruments for the purpose of achieving certain specific economic ends. The policy, however, has been directed to achieve various objectives according to different environs in the context of economic growth. The traditional aim, especially under the gold standard, was to maintain stability in respect of price and exchange. But the economic lessons of 1930s and the Keynesian Revolution had clearly unleashed the shortcomings of the traditional view of the monetary policy. The concept had undergone a radical change since the World War II and especially, when the Post-War reconstruction and the economic development had begun in several countries of the world.

3. Morgon, L. Victor, Monetary Policy for Stable Growth, Ch. II.


Economic development, however, depends upon real factors. Money by itself can not achieve real growth. But that does not mean that monetary policy is useless or has nothing to do with the economic development. On the contrary, a correct monetary policy is a condition precedent for the purpose of economic development which would otherwise be retarded. The monetary policy has thus been directed to create necessary condition for the effective mobilisation of the supply of actual and potential savings needed for the development even by the establishment of financial intermediaries, if they are really absent. A correct monetary policy has to direct the flow of funds in the required channels and to provide the institutional facilities for credit in specific fields of economic activity.

Monetary policy in a developed economy concerns chiefly with its regulatory aspect. But it plays a crucial role in a developing economy like India where the policy has to be one of "controlled expansions" to give credit facilities on the one hand and to restrain the inflationary pressure on the other. In the process of its work, in a developing economy, monetary policy suffers from inflationary pressures generated out of excessive credit creation.


5. E.S. Shaw, op. cit., p. 203.


If such inflationary pressures are allowed to operate freely then they will ultimately jeopardize the growth of the economy. Monetary policy has, therefore, to play a negative role in restricting the credit expansion to a particular level side by side with the positive role to expand the institutional credit.\(^{(10)}\)

A developing economy is associated with increased money supply, investment and monetization.\(^{(11)}\) All these do create inflation. Inflation arises out of and continues so long there remains a maladjustment between the increased real product and the increased money supply. In such an economy the propensity to consume is near unity which means any additional investment will increase consumption.\(^{(12)}\) Again if the capital formation lags far behind the investment then there is the fear of inflation. Quite naturally, monetary policy at this period has a vital role, to play, especially, by curbing the flow of credit to the undesirable and wasteful production. Secondly, it must put the 'steering wheel to right direction' so that the money supply must not exceed the real product in any way. Again, there must not be a stringency in the credit market which may deter the progress. Monetary authority has thus to regulate the money market at each and every stage of economic development. Thus arises the importance of monetary policy in relation to money market


\(^{11}\) Ibid, 1957-58, pp. 30-32.

\(^{12}\) Ibid, 1959-60, pp. 35-36.


Any successful operation of the monetary policy, however, calls for three things:

1) A strong central bank armed with effective instruments of credit control and to give a proper leadership to the money market.
2) A developed and integrated money market.
3) The banking habit of the people at large.

Unfortunately, the Indian money market did not have any central bank till 1935. The leadership in the money market was actually taken up by the Imperial Bank of India which was not only a private institution but also dominated by the foreign share-holders. The Reserve Bank of India started its career in 1935 when the whole monetary atmosphere was surcharged with the very spirit of economic depression. Because of its legislative rigidities, on the one hand, and monetary situation, on the other, it could not assume leadership in the market. Besides, the Reserve Bank was mainly confined to its policy of traditional pattern of credit control which was not efficient enough to control the changing monetary affairs day by day.

As to the second, Indian money market was not only undeveloped at the initial stage of our study, but also disorganised and divided into three distinct categories; (a) organised (b) semi-organised (c) unorganised. Not only they were unconnected with each other but there was absence of integration among the different sectors of the money market. Again, it is puzzling that the unorganised sector consisting of indigenous agencies which had financed about 90% of the total lending till 1949, had remained out of the purview of the Reserve Bank. These indigenous agencies were profusely scattered all over the country in such a way that it made it difficult for any monetary policy to become effective. For, all parts of the money market were not equally responsive.
Although the organised agencies maintained some sort of uniformity in their business and activities, yet they exhibited their differences anywhere. There were scheduled and non-scheduled banks and the latter remained for all sorts of practical purposes beyond the jurisdiction of the Reserve Bank till 1949. Even some of the scheduled banks were sometimes uncontrollable because of their sound liquidity position.

Besides, the Reserve Bank had no control over the rural economy. Cooperative sector which is considered as semi-organised sector had failed to serve the desired aims. They were too sick to enter the lower strata of the money market. This naturally created a gap in the rural areas to be covered only by the most unwanted indigenous agencies. All these had led Prof. Sayers to consider the problem of the Reserve Bank of India as one "to cope with hotch-potch of European Overseas banks, local banks of recent origin and European method, native banks that are really only money lenders and cooperative banks. (13) The market had really been charged with the absence of a coordinated relationship between the different categories of financial agencies, uniform pattern of business and activities among them, and an effective bill market which led to the financial crisis in rural areas.

As to the third, a large part of the economy had still remained relatively as non-monetised Sector. Agriculture in many areas was of the subsistence type rather than commercial in character. There was clearly no special incentive for commercial banks to extend their activities to such areas. The bulk of the savings of the community, however, small it was, did not really come to the investment market. Men of the modest means kept their savings with themselves, while, the rich held their investments in the shape of land and building. The habit of banking was really lacking among them. Capital in the shape of savings in the community was thus not only scarce but was also not easy to tap.

With these parameters in view, a successful monetary policy demanded, unquestionably, the following:

1) Early integration of the money market by establishing a link between the three sectors, especially to bring the indigenous agencies within its fold.

2) Better organisation of the organised sector of the money market by Act, 1949, better exercise of Banking Companies such as inspection and supervision, licensing, amalgamation, and by further amendments of the legislation.

3) Extension of banking facilities to both the rural and urban areas on the one hand and to create and establish some financial institutions for the purpose of financing agriculture and industry on the other.

4) Regulation of the money market by following traditional methods as well as modern techniques of credit control according to the changing monetary situation.

The purpose of this thesis is thus to explain the various efforts made by the monetary authority to achieve the avowed ends during the period of the whole plan.

ORGANISATION OF THE THESIS.

For the purpose of better appreciation of the monetary policy in relation to Indian money market it is necessary, first of all, to understand clearly the nature and composition of money market in India. Money market in India, as already pointed out, is categorised into different sectors such as organised, unorganised and semi-organised having no direct link between them. The methods of operation of these sectors differ greatly from each other. Chapter II makes an attempt to describe in detail the nature and composition of the different parts of the market, their respective position in the market and the relationship among them as well as with the Reserve Bank, especially at the Pre-Plan stage.
Having obtained a clear picture of the money market in India the next step is to evaluate the different aspects of monetary policy in relation to the Indian money market. Among the various aspects of the monetary policy the most important ones, for our purpose, are the policy to organise the structure of the money market by coordinating the different segments of the market, on the one hand, and by consolidating the organised part of the market, on the other, to promote and develop the structure of the market as a whole, and last but not the least, to regulate the operations of the market according to the desired level for the purpose of the Plan.

About the organisation of the money market the monetary authority had tried its level best on two directions —— by integrating the unorganised sector of the money market with the central money market and by consolidating the so-called organised sector of the market.

The idea of integration of the money market was in the air even before the coming of the Reserve Bank in limelight. The Central Banking Enquiry Committee had laid too much emphasis upon this problem of the money market and had pointed out that after the establishment of the Reserve Bank the problem should be studied and suggestions be made by the Bank itself on what lines the integration could be made. Chapter III of this work discusses the various attempts made by the monetary authorities to bring about the myriads of the indigenous agencies of the market within the fold of the central monetary control. It also analyses the problems encountered by the Bank in bringing about the money lenders as well as the indigenous bankers within its own jurisdiction. This chapter also shows how the successive attempts had failed in bringing about any satisfactory solution because of the point of difference between the Reserve Bank and the indigenous bankers on question of giving up non-banking business on the part of the indigenous bankers on the one hand and allowing the Bank to make inspection of the workings of the indigenous banks on the other.
On question of the consolidation of the money market, attempts had been made several times by the monetary authority since the establishment of the Reserve Bank. But no statutory powers were conferred upon the Bank to organise the structure of the money market till 1949. A systematic attempt was first made after the nationalisation of the Reserve Bank in 1949, especially by the passing of the Banking Companies Act, 1949. The Act conferred upon the Bank comprehensive powers to control the affairs of the commercial banks. The powers included inspection and supervision of banks, the power of giving license to banks, the power of amalgamation, the power to control over branch expansion and control over loans and advances of the commercial banks. The workings of this Banking Companies Act, 1949, along with the Reserve Bank Act, 1934, during the period of the first two Plans, have been analysed in Chapter IV. This chapter deals with the problems of consolidating the market and how, by different legislative amendments of the various provisions of the Banking Companies Act and the Reserve Bank Act as well, the monetary authorities had made several attempts to achieve a sound banking system.

The legislative amendments sought to remedy the defects of the working of the banks in particular and to strengthen the banking structure in general. A systematic bank inspection and bank supervision had been considered as necessary instrument for raising the standard of individual banks and eradicating the defects in the money market and toning up the banking system. Although this power had been conferred upon the Bank by the Banking Companies Act, 1949, yet this provision had been activated on and from March 1950. Similarly, the power of granting licenses to the commercial banks was intended to prevent the indiscriminate growth of the banking units and to weed out from amongst the existing units those working along unsound lines. The Bank had also helped throughout the period of the Plan to eliminate the weak and sub-standard banking units by making necessary arrangements for amalgamation and mergers.
Chapter V. is however a continuation of Chapter IV. This chapter analyses the workings of monetary policy during the Third Plan period to organise the structure of the money market, especially to strengthen the capital base of the commercial banks and to weed out the weak joints of the banking structure by persuasion, where possible, and by compulsory merger, if needed, of the small and weak banks.

The next part of our study is the promotional aspect of monetary policy. One of the most important aspects of the monetary policy is to control and regulate credit. But in an underdeveloped country like India, where institutional credit is lacking in vast areas, this aspect of monetary policy remains insignificant at least in such areas. Thus in a developing economy, the promotional aspect of monetary policy is just as important as the regulatory one. It is in this context that we have to analyse the various efforts made by the monetary authority to extend the area of organised commercial banking on the one hand and to help set up other financial institutions for financing both the industrial and the agricultural sector. In both cases, the attempt is to effect a transition from the individual to the institutional, from unorganised to the organised one. Chapter VI, VII, VIII have been devoted to study the various efforts made by the monetary authorities during the period of the Plan to increase the availability of finance to different sectors and to build up an integrated credit mechanism that would suit the requirements of a developing economy. Chapter VI has been devoted to study the extension of banking facilities to different parts of the country by a policy of branch banking, granting remittance facilities and clearing house facilities, and by institution of staff training to the banking personnel. Chapter VII analysed the expansion of institutional machineries for rural finance. The question of creation of new financial institutions for industrial finance has been discussed.
A related aspect of monetary policy, to promote and develop the money market, is to create and develop a Bill Market in India but for which the organisational and promotional aspects of monetary policy remain incomplete. An actively functioning Bill Market is a prerequisite for the purpose of effective rediscounting operations. Chapter II makes an attempt to study the efforts made by the Reserve Bank to create an active Bill Market and the very operations and development of the Bill Market Scheme in India.

Having obtained a clear picture of the organisational and promotional aspects of monetary policy in India and the extent of success in these spheres, the next step is to evaluate the regulatory aspect of monetary policy. The monetary policy pursued by the Reserve Bank during the period of the Plan, especially since 1956, may be termed as one of controlled expansion. While the need for expansion of credit and money supply commensurate with the rapid development and diversification of the economy was fully recognised by the Bank, an excessive expansion of money supply would be inflationary and would ultimately jeopardise the financial stability of the economy. Quite naturally, with considerable inflationary potential, the direction of credit policy should be one of general restraint without hampering the workings and progress of essential productive sectors of the economy. The Bank had sought to achieve this objective of 'controlled expansion' during the period of the Plan through the institutions of quantitative as well as selective controls in more flexible manner — some time by imposing an instrument, and some time, by withdrawing the same. The Chapter I attempts to evaluate the regulatory aspect of the monetary policy during the period.
Chapter XI makes an attempt to evaluate the role of monetary policy in general during the period of the First, Second and Third Plans. After having a thorough discussion of the different aspects of monetary policy in relation to Indian money market, Chapter XII makes a concluding observation.