Development Aspects of Central Banking: The Indian Case

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Developing countries such as India have been late starters in central banking. The evolution of central banking in these countries has been influenced by both, the central banking practices elsewhere in the industrial world as also the imperatives of the domestic economy. Since the overriding accent of these economies has been on achieving rapid economic development, inevitably, central banks in these countries have had a distinct developmental orientation.

Unlike several other developing economies, the central bank was established in India before Independence from the colonial rule. The Reserve Bank of India (RBI) was established as a private shareholders' bank in 1935 whereas India became Independent only later, in 1947. The then dominant developmental orientation meant converting the Reserve Bank from a private shareholders' bank into a nationalised central bank.

The primary developmental challenge for the Reserve Bank during the 1950s and 1960s was to build a financial network with a wide geographical spread, deep socio-economic reach and encompassing different tenors. Going beyond the conventional objectives of central banking, the First Five-Year Plan (1951) had noted that

> "…central banking in a planned economy…would have to take on a direct and active role, firstly in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly, ensuring that the finances available flow in the directions intended…".

An important step towards this objective was the formation of the State Bank of India, in 1955. Besides, the Reserve Bank promoted long-term

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industrial financing by establishing term-financing institutions, including the Industrial Finance Corporation of India (1948), State Financial Corporations (1952) and the Industrial Development Bank of India (IDBI) (1964) as well as a mutual fund entity, the Unit Trust of India (UTI) (1964). In line with its statutory mandate, the Reserve Bank has also promoted an appropriate structure of policies, procedures and institutions in rural financing, including the institution of the Agricultural Refinance and Development Corporation (1963). Contemporaneously, efforts were made strengthening of the co-operative credit structure, and improvement in credit delivery at the grassroots level, with a view to eliminating the exploitative informal sources of financing. Furthermore, the Reserve Bank offered a number of sector-specific refinance facilities, including export credit and food credit and established three national funds in order to finance long-term operations in agriculture and industry and also support agricultural stabilisation. This was backed by the institution of the necessary legislative framework for facilitating reorganisation and consolidation of the banking system, including the enactment of the Banking Regulation Act, 1949.

In the 1960s and 1970s, the challenge was to ensure that the financial system was able to channel resources from the saver to the investor, in tune with the wider objectives of development planning. A major step was the nationalisation of 14 large commercial banks in 1969. Banks were given ‘priority’ sector targets for agriculture and small-scale industries in the 1970s. Special schemes were introduced for the weaker sections, such as the Differential Rate of Interest (DRI) scheme in 1972 and Integrated Rural Development Programme (IRDP) in 1980. In continuation of the earlier phase of institution building, new specialised institutions were created for rural credit, including Regional Rural Banks (RRBs) (1975) and National Bank for Agriculture and Rural Development (NABARD), as well as export financing, in the form of the Export and Import Bank of India (EXIM Bank), both in 1982.

The objective of creating a large financial, especially banking, network was satisfied by the 1980s. Post-nationalisation, banking in India acquired a broad mass base and emerged as an important instrument of socio-economic change. The difficulty, however, was that the imperatives of "social control", in the form of credit controls and concessional lending, segmented financial markets and blunted the process of price discovery impinging thereby on the efficiency of resource allocation, and hence profitability of the banking industry. At the same time, the sharp increase in the Government's budgetary gap had to be funded initially by raising resources from the banking system by *fiat* by raising statutory liquidity requirements, and later by monetising the fiscal deficit. In order to neutralise the inflationary effect of deficit financing, the Reserve Bank had to raise reserve requirements, thus imposing an indirect tax on the banking system. By its worst in 1991 statutory stipulations came to account for as much as 63.5 per cent of the deposit mobilisation by the banking system, further limiting the scope for portfolio optimisation by the banking system. Furthermore, the imperative of maintaining low interest rates in order to contain the interest rate cost of public debt and to provide concessional credit to various sectors resulted in a degree of financial repression in the economy.

This led to the challenge of rejuvenating the process of price discovery so as to enhance the efficiency of resource allocation, without compromising on the social imperatives. This involved a three-pronged strategy of dismantling the regime of administered interest rates and directed credit, introducing new financial instruments and making financial markets capable of allocating resources in line with market signals, and at the same time, ensuring credit delivery for the relatively disadvantaged sections of society.

A series of policy initiatives were taken mainly at consolidation and diversification and to an extent, at deregulation in the 1980s. The consolidation measures included rationalisation of branch expansion while emphasising

coverage of spatial gaps in rural areas, institution of comprehensive action plans of organisational development by individual banks and greater focus on balance sheet strength. Banks were accorded greater operational flexibility, in terms of greater discretion in portfolio allocation, especially with the abolishing of the Credit Authorisation Scheme (CAS) in 1988, as well as fresh business opportunities in equipment leasing (1984) and mutual funds (1987). The process of financial liberalisation in terms of rationalisation of the interest rate structure and development of financial markets, especially money markets, took root in the late 1980s. The Reserve Bank also promoted two primary dealers, including the Discount and Finance House of India (DFHI) in 1988 to act as market makers in the money markets. The Small Industries Development Bank of India (SIDBI) was set up in 1990 to provide finance for small-scale industries.

The process of financial sector reforms gathered momentum in the 1990s, as a part of the overall programme of reforms in the aftermath of the unprecedented balance of payments crisis in 1991. In line with the increasing market orientation of the economy, the very form of the developmental orientation experienced a dramatic change. The earlier regime of administered interest rates and credit controls were replaced by an incentive structure to channel funds in tune with the spirit of financial liberalisation and the imperatives of poverty eradication. Besides, the Reserve Bank has since been spearheading the modernisation of the financial system through the development and diffusion of information technology, and improvement in trading and settlement practices, including the gradual migration to a real-time gross settlement system (RTGS). At the same time, the conventional monetary policy objective of price stability, which had acquired an important dimension in developing economies, especially since inflation tends to be iniquitous in the sense of hurting the poor the most, is no longer as relevant. By the mid-1990s, inflation has been reigned in, and has of late been around five per cent.

The Reserve Bank now accords substantial freedom to banks in determining their portfolios as well pricing their products, except in specific cases such as interest rates chargeable on small loans and priority sector advances. Statutory pre-emptions have been progressively reduced to the minimum (25 per cent in case of Statutory Liquidity Ratio) or close to the minimum 4.5 per cent (in case of Cash Reserve Ratio). The Reserve Bank is gradually divesting its investments in term-lending institutions - including phasing out concessional finance in the form of national funds – and doing away with sector-specific refinance facilities, which often resulted in market segmentation. At the same time, prudential norms have been instituted and supervisory framework strengthened for financial institutions to ensure financial stability. The Reserve Bank now offers incentives to banks in the areas of infrastructure financing and housing loans.

The Reserve Bank has undertaken several measures to strengthen the credit delivery system, especially to the disadvantaged sections of society. Although banks are still required to earmark 40 per cent of their advances for the priority sector, the definition of the priority sector has been considerably widened - and besides, the shortfall, if any, can be deposited with the NABARD's Rural Infrastructure Development Fund. Another new development is the experiment of micro-finance, through self-help groups either funded by banks directly or through intermediaries, such as non-governmental institutions. The Reserve Bank is strengthening the supervisory framework of co-operative banks and non-banking financial companies, which are able to meet localised and sometimes, specialised financing requirements through their localised network because of their relative organisational flexibility.

The concept of development central banking in India has thus shifted course over the years, responding to the contemporary challenges of economic development. Just as it was necessary to build institutions to monetise the

economy in the 1950s, the very process of financial deepening prompted the financial institutions to function efficiently by the 1990s. The Reserve Bank thus continues to play a key role in the progress of economic development in India in tune with the changing macroeconomic environment.

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