The Indian Money Market

by

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In general terms, the Indian banking system may be divided into two main sectors: that which concerns itself with commercial banking (as that term is commonly understood in Western countries); and that which derives from indigenous banking practice, with a tradition going back many hundreds of years. It would be wrong to suppose that these two sectors are wholly unconnected with each other, but the links which exist are somewhat tenuous and complete integration into a unified system has yet to be achieved. Underlining this dichotomy is the restricted use made of the cheque. In any extensive sense, it is still true to say that the banking habit is relatively undeveloped and the use of banks tends to be confined to the larger commercial centres. Banking in its sophisticated forms is very much an urban institution in India, though even in the cities and towns much business is transacted by indigenous institutions which are not banks in the accepted sense of the word. At the same time, the cheque as an instrument of commerce is supplemented in a very important way by indigenous credit arrangements. Even so, for much of the rural population, which is largely illiterate, organised banking arrangements scarcely exist. In consequence — and looking at the country as a whole — we find, first, that the use made of bank credit is relatively restricted; second, that the majority of transactions involve the direct employment of notes and coin; and, third, and even more obviously beyond the influence of banking institutions, that many transactions are still effected on a barter basis. Super-imposed on all this is the hoarding habit, which appears to provide an almost bottomless pit for the absorption of gold and silver. This is the background against which to view the organisation of banking in India.

I

At the heart of the system is, of course, the Reserve Bank of India, first established in 1934 and nationalized in 1948. The structure of the Bank was largely modelled on that of the Bank of England. It was divided into two departments — an Issue Department and a Banking Department — to be kept separate and wholly distinct. It was accorded the traditional powers of a central bank, though there were certain limitations on the types of securities, which were eligible for purchase and rediscount. It was also to publish from time to time a « standard rate » at which it was prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act. In addition, the Bank could resort to what was called its « power of direct discount », in cases of « special urgency ». This enabled it to relax the statutory eligibility rules — if the occasion demanded it — in so far as these required it to deal direct with specified bodies only (*e.g.* the scheduled banks) and to offer help direct to those in need of it. As well as the influence the Bank might exert on the cash base through the medium of open market operations, the maintenance of minimum deposits with the Reserve Bank was ensured by the requirement that the scheduled banks must keep with the central bank deposits which should be not less than 5 per cent of demand and 2 per cent of time liabilities. In summary, the Reserve Bank was to serve as the Government's

banker; it was accorded the sole right to issue notes and was required to manage the note issue; it was « to regulate ... the keeping of (banking) reserves with a view to securing monetary stability ... and generally to operate the currency and credit system of the country to its advantage »; and it was under an obligation to buy and sell overseas exchange for the purpose of maintaining the external value of the rupee.

Grouped around the Reserve Bank and forming the body of the « central money market », we have the commercial banks. These may be divided into two main groups — the « exchange banks » and the Indian joint stock banks (both « scheduled » and « non-scheduled »). The exchange banks (of which there are now fifteen operating in the country) constitute the oldest and most homogeneous group of banks in India. They include such famous names as the Chartered Bank of India, Australia and China; the National Bank of India; Lloyds Bank; the Mercantile Bank of India; and the Hongkong and Shanghai Banking Corporation. These banks have been foreign (*i.e.* non-Indian) in origin and their methods are primarily derived from British and particularly Scottish experience. At times, and in certain quarters, they have been regarded with some suspicion, but their strength in periods of crisis appears more recently to have created a new respect. Every confidence is now placed in their ability and willingness to meet fully their responsibilities to the community. They are not, of course, confined in their activities to India alone, but this country (with Pakistan) is one of their most important spheres of operation. Within India, the offices of these banks are concentrated mainly in Bombay and Calcutta, with minor groupings in Delhi, Madras, and Kanpur. The exchange banks specialise in the finance of foreign trade, in which they still have a near-monopoly of the better-class business (1). They also play some part in the financing of internal trade, in order to assist the movement of goods between up-country centres and the ports, but their general banking business is related as far as possible to the auxiliary financing of the export and import trades. Of all the « Indian » banks, as the non-exchange commercial banks are called, the Imperial Bank of India is the largest and most powerful. It was constituted in 1921 as a semi-public institution by amalgamating the three Presidency banks in Bombay, Calcutta, and Madras. It fulfilled the functions of an interim central bank until 1935, when the Reserve Bank began its operations. It has a network of branches and pay offices covering every town of commercial importance in India (besides continuing important services in Pakistan). As agent of the Reserve Bank of India, it still retains part of its former official functions. Since 1934, when the Reserve Bank was established, it has conducted a general banking and foreign exchange business similar to the other commercial banks, and it is still an important lender to them in the local money markets of Bombay and Calcutta. Apart from the Imperial Bank (which is in a special category), the biggest of the Indian commercial banks is undoubtedly the Central Bank of India. It is followed in order of size by the Bank of India, the Punjab National Bank, the Bank of Baroda, the United Commercial Bank, and the Allahabad Bank (now a subsidiary of the Chartered Bank). These are followed by somewhat smaller but still large banks, though immediately below them will be found banks which are almost as big and there is, indeed, an almost uninterrupted gradation downwards to banks which are quite small. To be « scheduled », a bank must have a paid-up capital and reserves of at least Rs. 5 lakhs (approx. £stg. 7,500), but this scarcely provides the hallmark of security. All the larger banks have a network of branches, but these are somewhat unevenly distributed, with a heavy concentration in the larger centres. As many as 800 (out of a total of about 3,000) were situated in thirteen principal cities and towns, and this has led to much unnecessary overlapping and to a good deal of unhealthy competition both for deposits and advances.

(1) Latterly, however, the exchange business of the Indian joint stock banks has been expanding and they may in time present a more serious challenge to the exchange banks. Rates and terms are laid down by the Exchange Banks' Association, which the Indian banks are obliged to follow, though they are not members.

The activities of the commercial banks follow a fairly uniform pattern. All the larger banks accept deposits both on current account and as fixed (or time) deposits (though some small banks accept fixed deposits only and do not hold current accounts at all). Most banks keep savings bank accounts (subject to limited drawings by cheque), the exceptions being the majority of the exchange banks. Usually, a nominal rate of interest is paid on such current accounts as to maintain the required minimum balance. Fixed deposit rates vary with the term for which money is fixed. Accommodation is made available by means of loans, « cash credits », overdrafts, or the discount of bills. Loans are made in fixed amounts and are repayable in arranged instalments, while overdrafts are a more elastic type of lending. In the latter case, a « limit » is agreed up to which the account may be overdrawn and, although the overdraft is technically repayable on demand, it may be allowed to run on indefinitely. The « cash credit » is really a special form of overdraft. It is an advance made in overdraft form to finance the holding of stocks. Though theoretically repayable on demand, in practice the cash credit is allowed to run for 6 or 12 months. The object is to provide working capital on a seasonal basis and it is, in effect, an advance made against a pledge or hypothecation of goods. In all cases, a certain margin of security is, of course, required. « Joint and several loans » — another form of lending — are a special feature of Indian banking. They are demand loans, for which security is taken on two signatures in promissory note form, though again such accommodation may run on for a period of months. Elasticity can be provided by successive renewals. All « joint and several borrowers » are restricted by « limits » to the accommodation they can seek in this way. Another specialized form of lending is found in Calcutta, where the banks normally provide finance to the jute industry against « jute delivery orders ». The business is subject to a monthly settlement, though orders which are retired may be replaced immediately by new ones. The so-called «demand hundi » is also treated as an « advance », though the document is drawn in bill of exchange form. They are used primarily to finance trade between up-country centres and the ports, the usual procedure being to draw sight bills for this purpose and then to secure cash credit accommodation to cover the holding of stocks on arrival. Usually, there are no supporting documents, though (in some cases) railway receipts or a bill of lading may be attached. Bills are used primarily by the exchange banks as a means of financing exports and imports. These bills are discountable in London and do not come on to the Indian money market. In addition to the London bill (which caters for overseas commerce), a good deal of internal trade is financed by means of the usance « hundi » — the true « hundi ». This is made out in promissory note form, payable so many days after date. Normally, days of grace are allowed. A « hundi » will be made by a small Indian businessman in favour of a Multani banker, who discounts it (at a rate up to 9 per cent in Bombay and Calcutta) and thereby becomes the lender. Ordinarily, no value will have been received and the transaction will be purely of an « accommodation » character. Usually, the Multani banker then endorses the hundi and, by arrangement through a hundi broker, re-discounts it with a scheduled bank at a rate of 3 to 4 per cent per annum. The Multani banker, or « shroff », has limits (often with several banks) up to which he may expect his hundis to be discounted. It is in this way that the Multani banker acts as an intermediary between the joint stock banks and the small trader, about whose creditworthiness the banks will not normally have any detailed information. Only four or five of the scheduled banks discount the true hundi and of these the Imperial Bank does by a far the largest business, with the Bank of India and the Central Bank of India doing the bulk of the remainder.

Bills discounted now represent no more than 3 to 4 per cent of total accommodation granted by the banks, due (it is said) to the less expensive character and more convenient form of borrowing by way of overdraft or cash credit. The bulk of the advance business — 68 per cent — is done by the Indian scheduled banks. The exchange banks are responsible for 25 per cent and the non-scheduled banks for the remainder. Scheduled bank advances and bills discounted represent between 45 and 50 per cent of total deposits which compares with 55 to 60 per cent for investments. (For non-

scheduled banks, the advance-deposit ratio approximates to 75 per cent and the investment ratio is slightly over 30 per cent). Nearly half the total of scheduled bank advances are for commercial purposes and about one-third goes to industry. Production credit for agriculture is small. Personal and professional advances constitute about one-tenth of the total, though portions of these are used for business. Of the aggregate advances of all commercial banks, something like 78 per cent are secured, the most popular form of security being bullion, including gold and silver ornaments. About a quarter of unsecured advances are made against « clean » bills (*i.e.* no documents attached) and, in part, represent the finance of trade. Advances of a highly liquid nature, such as those against merchandise and documentary bills constitute nearly half of total advances, those against Government securities and readily marketable shares nearly a quarter, and those against real estate 6 per cent. The cotton industry is the largest single industrial borrower, and, together with jute and sugar, absorbs half the industrial finance provided by the banks. The credit extended to basic industries, such as engineering, coal, cement, and public utilities, appears to be quite small.

Among the non-scheduled banks, loans for consumption predominate. The amounts advanced to « personal » borrowers and against the security of bullion are relatively much higher than in the case of scheduled banks. Advances against merchandise amount to about 21 per cent of total advances, as against 42 per cent for scheduled banks. Advances against real estate are nearly four times those of the scheduled banks and this is particularly true of the smaller non-scheduled banks.

II

As has been indicated, joint stock banking in India is concerned primarily with an urban demand, though even in the cities and towns there also exist indigenous institutions, which cater for the many small manufacturers and traders. These may borrow by way of mortgage or by means of hundis. A good deal of the indigenous banker's business, however, derives from up-country trade. Indeed, it has been estimated that the indigenous bankers finance nearly 90 per cent of India's internal trade. Nevertheless, it is in the rural areas that the indigenous institutions find most scope for their activities. India is still primarily an agricultural country and her social life is therefore based on her village communities. Hence, the importance of indigenous institutions. The latter may be roughly divided into the indigenous bankers and the moneylenders, but the two groups merge one into the other. The banker, however, generally supplements his resources by accepting deposits from the public, while the moneylender trades primarily on his own capital, though he may raise additional funds by borrowing from other institutional lenders. Generally speaking, the indigenous banker combines banking with other forms of business. They range in size from firms which are little more than petty moneylenders to substantial « shroffs », who carry on a large and specialized business, which at times exceeds that of some of the scheduled banks. It has not been their practice to publish balance sheets, and they are disinclined to introduce modern methods into their business, which have been carried on for centuries in accordance with an established tradition. Indeed, those who undertake this type of business will usually be found to belong to certain castes or communities, such as the Multanis or Marwaris.

The Multanis work mainly with their own resources. Their headquarters was formerly in Shikapur (now in Pakistan), but they have now spread all over India, concentrating their activities in the cities and towns. They borrow from certain of the joint stock banks, which they regard as the appropriate source of their marginal finance. In addition, the Bombay and Ahmedabad shroffs lend money amongst themselves at comparatively low rates of interest (4½ to 6 per cent). The Multani restricts himself to his banking business (primarily a hundi business) and regards himself as prohibited by convention from accepting the risks of trade, which would only serve to multiply his lending risks. The Marwari, on the other hand, is not so inhibited. He is a merchant banker. He deals as a merchant, lends money, and also does a hundi business. Usually, he

lends against goods by way of pledge supported by a demand promissory note or usance hundi. He may even accept a mortgage, either as primary or collateral security. The Marwari bankers prefer to rely on funds from within their own community, but they also accept deposits. Furthermore, the popularity in both Bombay and Calcutta of the « Marwari loan » (as borrowing from the banks on a joint and several promissory note is sometimes called) suggests a growing dependence on bank finance to cover the marginal needs of the busy season.

The fact that indigenous bankers are drawn from banking castes or communities accounts for the influence of tradition on their methods. The indigenous banker is brought up to his calling. Generally speaking, he receives no special banking education. He draws on the experience of the past, both that of his firm and latterly his own. From the point of view of the borrower his chief virtue is the absence of formalities and delays. Besides this informality, the indigenous banker is accessible. His lending policy is flexible and, though he may appear to take more risks than his joint stock counterpart, his closer personal knowledge of his customer to a large extent offers a measure of protection not available to larger institutions. The joint stock banks, on the other hand, investigate the nature of the security much more closely and, in any case, their managers cannot have the same margin of discretion as the small man.

As a general rule, it is not practicable for the indigenous banker to establish direct business relations with the agriculturalist, though indirectly he may assist in the finance of agriculture by making funds available to local « sowkars » (or moneylenders). Also, by lending to grain merchants, indirect help is given to agriculture by financing the trade derived from it. But, for many years, agricultural credit facilities were provided almost entirely by the village « sowkar » or « bania » (*i.e.* by local moneylenders). The Indian peasant, or « ryot », was his chief customer. These small farmers had little credit to offer and no joint stock bank, even if it had a branch nearby, would be willing to lend. Where liquidity is the main consideration, the small landholder with his crop only ready for harvest after about eight months could scarcely expect to borrow from the commercial banks. In any event, a branch of a joint stock bank is a rare phenomenon in rural India. Hence, the moneylender had for long been an indispensable adjunct to village life. But it became a matter for general comment that, although most accommodating in providing finance for all purposes (marriage and funeral loans were probably the most important of the non-productive types of borrowing), relations between the moneylender and the villager steadily deteriorated over the years. Formerly, the moneylender was restrained by various conventions and by public opinion, but with the introduction of Western legal arrangements the tendency was for these restraints to weaken and for the letter of the law to be enforced. In this respect, the appalling illiteracy of the peasant played right into the hands of the man on whom he so vitally depended for his finance. However, the balance of blame was by no means all on one side. It was not unkown, for instance, for a ryot to hypothecate his crop to one person and then quietly to sell it to another. The moneylender retaliated by taking bonds for larger amounts than had actually been lent (and there were many other malpractices) and he regarded this as merely a regulation of his dealings such that he indemnified himself against risk of loss. It is true that he charged usurious rates of interest, but there were often wide discrepancies between the rate of interest stipulated in the contract and that which he was finally able to collect.

The methods of business of the urban moneylender were almost the same as those of the man operating in the villages, except that the urban moneylender often advanced on the basis of hundis and his operations were on a larger scale. He, too, was accustomed to combine the business of moneylending with ordinary trading.

Over a period of years, various attempts were made to regulate the activities of the professional moneylenders and to restrict the worst abuses. But ignorance of the law, illiteracy, and the ease with which loans could be had from this source rendered much of this legislation inoperative. Latterly, however, the legislative requirements have been made much more

stringent and, even more important, the nature of these provisions has become more widely known. The effect has been the virtual disappearance of the professional moneylender from many areas. Taking into account the risks involved, it has no longer seemed worth his while to operate under the new provisions. He has therefore chosen to change his calling and to become a merchant or trader, though probably he still carries on an illicit moneylending business on a restricted scale.

The decline in the importance of the professional moneylender has had two effects. First, a vacuum has been created which existing institutions have not been able to fill and there is in consequence a great dearth of credit in the villages. It has been estimated that the co-operatives, for example, only cater for from 5 to 10 per cent of the financial requirements of the rural areas and, even where their services are available, they are not nearly so ready to lend. They investigate the ryot's affairs more closely than did the sowkar; they require security and adequate arrangements for repayment, whereas the sowkar used to lend with no questions asked and repayment was often not insisted upon, provided the interest was duly met. As a result, the villager today finds borrowing difficult and suffers much inconvenience. Second, and because of the villager's insistent demand for accommodation, the non-professional moneylending groups, which have always operated to some extent, are increasing in importance. Thus, it is not uncommon — even in villages where co-operatives exist — for the larger landowners and wealthier ryots to lend to the poorer members of their community, frequently at high rates of interest which the borrowers are quite prepared to pay.

As has been mentioned, there are in existence certain links between the commercial banks and the indigenous institutions, but so far as the smaller indigenous bankers and moneylenders are concerned they are still very indirect. The Reserve Bank has already attemped to bring the indigenous bankers into more direct contact with the central money market, though with somewhat indifferent success. For example, in 1937, it offered the indigenous bankers facilities of direct discount and advances against Government securities, as well as remittance concessions, subject to their shedding their non-banking business, maintaining proper books of account (which would be open to the Bank for inspection), and the filing of periodic statements similar to those supplied by the scheduled banks. But the indigenous bankers were not prepared to accept these conditions and preferred to continue the old arrangements whereby they received accommodation from the Imperial Bank and other scheduled banks. Nevertheless, the Reserve Bank left its offer open and remained ready to take up the matter again, if the indigenous bankers did decide to conform with its conditions or could suggest any other practicable alternative. More recently (1951), the Governor of the Reserve Bank took the opportunity of addressing a conference of indigenous bankers meeting in Bombay in order to re-state the Reserve Bank's views and there are signs that in the near future it will make an even more determined effort to secure greater integration. As a preliminary step, it has embarked upon an India-wide survey of indigenous credit arrangements and it is hoped on this basis eventually to modify considerably the existing arrangements.

III

Supplementing the work of the indigenous institutions are the several species of co-operative banks. These provide, first, one of the two main links (the other being the endorsing shroff) between the sophisticated institutions of the central money market and the credit needs of both the rural village and the smaller artisans of the towns. Attempts have been made in recent years — by formalizing relations between the provincial co-operative banks and the Reserve Bank — to strengthen this link, but the integration is not yet by any means complete. Second, it was intended that the primary co-operative societies should provide credit facilities in direct competition with and as an alternative to the moneylender.

The main function of the agricultural co-operative societies has been to supply rural credit and to educate the farmer in the practices of co-operation and thrift. More recently,

there has been a shift of emphasis to the multi-purpose potentialities of co-operation, such as the development of marketing and procurement facilities. From the depression of the early thirties to the outbreak of war in 1939, the progress of the movement was rather discouraging, when compared with the pre-depression period. During the war, however, the position improved, as was reflected in the increase of working capital from Rs. 106 crores in 1938-39 to nearly Rs. 164 crores in 1945-46 (Rs. 1 crore equals £stg. 750,000 approximately). But this increase in working capital, substantial though it appeared to be, was not in proportion to the war-time inflation, due perhaps to the societies' own disinclination to augment funds unduly at a time when the demands of borrowers were decreasing. Another not unimportant reason may well have been that, once the farmer cleared his more burdensome debts out of his increased war-time earnings he lacked the incentive to save further and soon lapsed into his traditional habits of improvidence. As a result a unique opportunity was lost in not augmenting working capital by an expansion of members' deposits. Since the war, there has been some increase in advances to agriculture due substantially to the rise in working costs and the demand for improvement loans. Indeed, the Rural Banking Enquiry Committee, which reported in 1950, referred to the experience of considerable financial stringency in rural areas and stated that « the co-operative institutions are now faced with large demands for funds which they are unable to provide ». Further, as a result of the compulsory scaling down of agricultural debt and the fixing of instalments in which the adjusted debts are to be repaid, «the normal sources of finance have dried up » and the problem of making adequate provision for the needs of the adjusted debtors and other creditworthy agriculturalists has become urgent.

The legislative basis for the development of co-operative banking was provided by the various provincial Co-operative Societies Acts, dating from 1904. The foundations of the system are the village or « primary » societies, which are generally linked with « central banks ». These, in turn, are affiliated with the provincial banks. A village credit society can be formed by the association of a minimum of 10 members, who then apply for registration. Where the majority are agriculturalists and the object is « the creation of funds to be lent to its members », the liability of members is unlimited. The internal resources are derived from entrance fees, members' deposits, and surplus assets held in reserve. External assistance is obtained from « central » and provincial banks, and from the Government. Accommodation is also available, under certain conditions, from the Reserve Bank of India. These funds are then lent out to members at moderate rates for current and short-term purposes. The uses to which loans are put should be strictly productive, but loans for non-productive purposes, which are « necessary and unavoidable » (*e.g.* marriage loans) may also be granted from time to time (though with due care) to prevent a member seeking accommodation elsewhere at usurious rates of interest. The period of repayment depends, among other things, upon the purpose for which a loan has been granted and may vary from three months to three years.

The structure of the co-operative system is federal in character. There are good reasons for this form of organisation. A number of scattered village banks working independently could only achieve rather limited results. More capital was required than could be raised from local sources and some form of federation was therefore seen to be necessary, not only for the purpose of securing access to larger amounts of capital but also in order to spread risks. With this object in mind, the village banks were grouped under « central banks », which were better placed for the attraction of deposits from the public. They covered a larger area and were able to contact urban dwellers with whom the banking habit was more developed. Furthermore, the liability of the central banks was limited and the management was in more capable hands. It was natural therefore that they should attract deposits more easily from the middle classes. The village societies were, of course, members of the central banks, but the bulk of the latter's deposits came from private individuals, who placed money on deposit for fixed periods. These

moneys were then usually lent short-term to the primary societies, though latterly some of the central banks have undertaken a commercial banking business as well, as a means of employing surplus funds. However, commercial banking strictly lies outside the sphere of the co-operatives and, while certain authorities are in favour of its extension, it is frowned on by the Reserve Bank itself. Lending funds to village societies is regarded as the main function. However, such lending might lead to embarrassing situations. Money might have been lent to one village and would not therefore be available to another. In these circumstances, co-ordination of provincial finance and supervision of the central banks themselves became necessary, if money was to be obtained on reasonable terms. This co-ordination was supplied by what were called provincial or « apex » banks. (In districts where there were no « central banks », a provincial co-operative bank would provide the necessary facilities direct to the village societies). In this way, a federal structure was provided, though it was not always availed of.

An attempt to meet the long-term requirements of agriculturalists has also been made by establishing land mortgage banks, but such banks are few in number and of comparatively small resources, except in Madras.

In addition, there are non-agricultural societies called « urban » banks. These cater for the needs of small traders, artisans, their employees, and Government servants. This branch of the movement is concerned with a much smaller population than the agricultural societies, but from the point of view of working capital and the amount of business turnover it has definitely reached larger proportions.

More success has been had with the attempt to link the co-operative banks to the central money market than attended the Reserve Bank's efforts to bring the indigenous bankers into closer contact. Thus, in January, 1942, the Reserve Bank propounded a scheme for extending financial accommodation to the co-operative central banks through the provincial co-operative banks, for the purpose of financing seasonal agricultural operations, or the marketing of crops, at special rates of interest. Under this scheme, it was proposed to grant a rebate of up to 1 per cent to provincial co-operative banks re-discounting agricultural bills with the Reserve Bank, provided the benefit of the rebate was passed on to agriculturalists. Later, as a special case and on an experimental basis, this rebate was raised to 1½ per cent. This was in addition to the existing arrangements under which accommodation was granted to provincial co-operative banks against Government securities. At first, very few applications were received, but gradually the system gained in popularity and the Bank was approached with increasing frequency. During the four years ended June, 1947, the provincial co-operative banks drew only Rs. 3.25 lakhs from the Reserve Bank. In the year ending June, 1948, the Bank sanctioned credit limits to the extent of Rs. 67.70 lakhs and for the following year Rs. 180.25 lakhs, and applications were much heavier than those actually granted. This practice has now become an established part of agricultural finance and, besides making cheaper credit available to the co-operatives and their clients, it has had the effect of linking the co-operative banks much more directly to the central money market and has assisted in the development of a more unified system.

IV

So far, the discussion of the structure of Indian banking has been in terms of its two main sectors — on the one hand, the commercial banks, and on the other, the indigenous and co-operative institutions. Little has been said about the relations between the two. In certain respects, these two sectors are relatively distinct, but there is, of course, some sort of connection between the several types of activity described and these links have been forged most obviously in the money markets of India's main commercial and financial centres. In this connection, it is sufficient to concentrate on the financial organisation of the two main centres — Bombay and Calcutta. Calcutta is still by far the larger, but Bombay has grown steadily in importance. Both are centres of industry and commerce, with developed stock exchanges. Both are major ports. Bombay possesses two leading markets in bul-

lion and cotton, while Calcutta deals in considerable quantities of jute. Madras is much less highly developed than the other two and tends to follow the lead of Calcutta, though it also has connections with Bombay. Banking in Madras is rather « provincial » by comparison with the main money markets. Interest rates are rather higher and less competitive. The call money market is scarcely a true market and inter-bank lending is arranged by direct contact. Nor is Madras a true « centre », since much of its business is done on an agency or branch basis for firms in Bombay and Calcutta. The volume of transactions does not permit of the same degree of specialisation as we find in the two more developed markets.

In essence, a money market is a place where the borrowers and lenders of short-term funds are brought together. It is usual to think of the Indian money market as being « undeveloped ». This may well be true, but it is wrong to ascribe this lack of development mainly to the absence of a discount market. A money market must be a product of its environment and simply because certain markets have been built up on the basis of particular classes of business is no reason for believing that all money markets must follow the same pattern. Even in the absence of a discount market, there may still be in evidence a system of organised relationships and a specialisation of function, similar to — though not identical with — those characteristic of money markets elsewhere. Indeed, it would seem that the weakness of Indian market arrangements lies in the looseness of its arrangements and its lack of integration rather than in the absence of particular specialisms.

The money markets of Bombay and Calcutta may be divided into two main sectors — along the lines of our earlier analysis. On the one hand, we have the « central money market », which (apart from the Reserve Bank) includes the exchange banks, the Imperial Bank, and the other Indian commercial banks; and, on the other, we have the indigenous market, which consists of a group of bazaar markets, each with different business practices and a different structure of rates. Within both these two main divisions, quite a high degree of specialisation has developed, including some provision of facilities for the flow of funds between them. The chief weakness lies in the links between the main sectors and, until these have been considerably strengthened, further integration will be difficult.

The types of business undertaken by the commercial banks have already been described, but it is appropriate to consider further the extent to which markets may be said to exist for call money and bills. The call money market is restricted almost entirely to dealings between banks, though other institutions and even individuals sometimes come into the market as lenders. This market is fairly active in Bombay, rather less so in Calcutta, and in Madras scarcely exists at all on an organised basis. In all three centres, the exchange banks are the chief borrowers, because of the highly seasonal nature of their business. Moreover, they are accustomed to work with a comparatively small cash base and this means that they may often be in need of funds for a day or so (*e.g.* when bills offering exceed bill maturities). Temporary stringencies of this kind are therefore tided over by borrowing money at call or short notice. In addition, such borrowings are the means of mobilising funds and employing economically such money as is available at the height of the busy season. Thus, in a very real sense, the exchange banks lie at the centre of the money market in India. Nevertheless, some of the Indian banks are also known to borrow in this market. Normally, they maintain fairly large cash reserves and are not in need of call money, but « window-dressing » is common and they may therefore go into the market for this purpose. In addition, it is thought that the statutory provision for the maintenance of minimum balances with the Reserve Bank has served to increase the periodic demand for call money in recent years. Inter-bank call money is usually arranged through brokers, but temporary funds may be obtained by approaching other banks directly. Very few banks — mostly the exchange banks — can obtain « clean » call money (*i.e.* without collateral security) and, where money is lent against Government securities or Treasury bills, the transaction becomes in effect a collateral loan. Obviously, the rate for inter-bank call money will vary with the state of the market and be higher in the

busy season than when business is slack. Thus, there tends to be a decline in demand (and in rates) in May or June, with a rise again in November or December. The influence of seasonal demand is paramount, but short-term factors may result in day-to-day fluctuations. Thus, heavy Treasury bill maturities may cause funds to be in surplus for a day or so and depress the rate, or a heavy demand for funds to finance speculative dealings on the stock exchange, or the bullion or commodity markets, may drive the rate up. In the main centres, therefore, the call money market is both developed and sensitive to changes in the conditions of overall liquidity.

On the other hand, the bill market, as it has existed for many years, has been a much more dependent phenomenon. All the principal banks in India and, in particular, the exchange banks, discount approved bills and there is a degree of specialisation in the types of bills dealt in, but, until the recent experiment (described below), there was no true market in India for further dealings in these bills. Either bills discounted were carried in bank portfolios until maturity, or — as with export bills — they were rediscounted by the exchange banks in the London market, which procedure served the interests of economy. Rediscount facilities existed both at the Imperial Bank (which, for many years and even after the establishment of the Reserve Bank, provided the bulk of rediscount facilities, since its rates were lower than those available at the central bank) and at the Reserve Bank, but this was more in the nature of last resort accommodation, with the Imperial Bank serving as a kind of « intermediate » lender of last resort. The market was therefore « dependent » in two senses: (a) on London; and (b) on a direct relationship with the lenders of last resort. These arrangements were not without merit, insofar as they resulted in economies which would not otherwise have been available under Indian conditions. There is, for example, really no very strong case for the establishment of discount houses on the London model. The difficulties which arose were due rather to the somewhat narrow criteria on which approval for rediscounting was based and the remedy has therefore been sought in widening the range of eligibility.

Over recent years, the scheduled banks have normally provided themselves with additional funds for meeting their seasonal requirements either by a sale of securities to the Reserve Bank, or by borrowing from the Reserve Bank against Government securities. This system had obvious limitations and the Reserve Bank therefore decided (in January, 1952) to « create » a bill market. This had been in contemplation for some time and the experimental scheme was finally evolved in consultation with representative bankers in Bombay and Calcutta. The Reserve Bank was already permitted under its Act to make advances to scheduled banks against the security of usance promissory notes, or bills drawn on and payable in India and arising out of bona fide commercial or trade transactions bearing two or more good signatures, one of which had to be that of a scheduled bank, and maturing within ninety days from the date of the advance. Under the new scheme, advances will be granted to scheduled banks in the form of demand loans on the execution of demand promissory notes supported by usance promissory notes taken from bank customers. For this purpose, it will be necessary for the scheduled banks to convert at least a portion of the demand promissory notes obtained by them from their customers in respect of loans, overdrafts, or cash credits into usance promissory notes maturing within ninety days. It was proposed that advances by way of demand loans against the security of eligible bills would be made at the offices of the Reserve Bank in Bombay, Calcutta, Delhi, Madras, and Kanpur in respect of advances granted by scheduled banks anywhere in India. But, before extending credit, the Reserve Bank would take into account not only the nature of the security offered, but also the manner in which the business of the bank concerned was being conducted, and the Reserve Bank might refuse to accept the bills of any particular scheduled bank without assigning a reason. In order to encourage the rapid development of such a bill market, it was proposed that these advances should be made at a rate ½ per cent below Bank rate, though naturally the Reserve Bank reserves to itself the right to raise the rate at its discretion. Bank rate is now 3½ per cent (having been raised from 3 per cent last November). The attractiveness of the new arrangements is underlined by the competitive nature of the Reserve Bank's present offer, as compared with the terms now available from the Imperial Bank, whose call rate for loans to scheduled banks against Government securities is now 3½ per cent for loans above Rs. 5 lakhs (this is the rate which most nearly corresponds to Bank rate), while its hundi rate (*i.e.* the rate at which it discounts first class three months bills) is now — at 4½ per cent — one per cent higher than Bank rate. As a further inducement to banks to help create a bill market, half the cost of the stamp duty incurred in converting demand bills into time bills will be borne by the Reserve Bank. As the main object of these proposed advances is to relieve seasonal stringency, the minimum limit for an advance which a bank may take from the Reserve Bank at any one time has been provisionally fixed at Rs. 25 lakhs. Individual bills tendered by scheduled banks to the Reserve Bank for similar advances must be not less than Rs. 1 lakh. In the initial stages, it was foreseen that there might be some delay in sanctioning advances on the new basis, because the Reserve Bank would have to make adequate enquiries in order to safeguard its position. If, however, a scheduled bank required an immediate advance, it could still get it against Government securities at the Bank rate, pending the completion of the enquiries. It was hoped at the time this scheme was introduced that with greater experience in its working it would be possible to simplify this procedure. It is, of course, too early as yet to comment usefully on the manner in which the scheme is working out.

Treasury bills deserve separate mention. These are short-term Government securities, issued for meeting Government requirements for supplementary finance, usually with a currency of three months being rediscountable with the Reserve Bank and generally issued during the slack season, they provide an ideal form of investment for the surplus funds of the banks. Government of India Treasury bills, which constitute the bulk of those available, are issued weekly by public tender through the Reserve Bank. In addition, « intermediate » Treasury bills are sold from time to time, generally to State governments which have surplus funds. Tenders are confined for the most part to a few large banks, the Imperial Bank taking up something like 40 per cent. Sometimes, the Reserve Bank may have to intervene itself to ensure a successful placement. Private individuals and institutions other than banks rarely tender for bills on their own account, preferring to purchase Treasury bills through their bankers. But many of the smaller banks do not hold Treasury bills, because they are accustomed to attract deposits at relatively high rates of interest and they are therefore obliged to invest even their temporarily surplus funds in longer-dated securities which offer a higher return. In addition to Treasury bills, the Government now obtains a considerable amount of money from the banks on the basis of Treasury Deposit Receipts, which have currencies of 6, 9, and 12 months.

Business done by way of rediscounting hundis has already been described and it is sufficient to recall here that approved shroffs have limits at certain of the larger banks for the provision of this form of accommodation and that it is the endorsing shroff who provides the link between the central money market and the indigenous markets (described below). The link is, indeed, somewhat tenuous and it is here that the lack of integration which is the chief characteristic of money markets in India is most in evidence. Only the better class of hundi is taken to the banks and the relation of this rate of rediscount with those charged in the bazaar markets proper is somewhat indirect.

No account of the money market structure would be complete without a passing reference to the stockbrokers. Both in Bombay and Calcutta, these constitute one of the most important classes of borrowers. Their marginal finance is derived by way of overdraft accommodation from the banks against the security of stocks and shares under blank transfer deeds. Advances are permitted only up to a certain percentage of the value of the securities deposited and, in recent years, these requirements have had to be made much more strin-

gent in order to curb the tendency to speculate. In the past, some of the less cautious banks have incurred heavy losses by becoming over-extended in this direction.

Since the degree of integration has been taken as our chief criterion of the extent of development of the Indian money market, it is appropriate at this stage to direct our attention to those specialists who maintain contact between the several parts of the market. These are the various kinds of brokers. The most general type is the « finance broker », who may combine exchange, deposit, and share broking. It is more common, however, especially in Bombay, for exchange and deposit broking to be in the hands of specialists. Deposit broking is an interesting institution. Inter-bank lending, for example, is arranged by these brokers, and « house money » (surplus cash available from business houses and private individuals of standing) is placed with the banks which (as borrowers) pay the brokerage. Even fixed or time deposits may be made through the agency of a deposit broker. Again, there are instances of recourse to a broker in the lending field. Thus, the renewal of " joint and several loans " made by the banks to merchants may be arranged through a broker. The bank may lack the special knowledge of a customer's current position to deal direct and may therefore depend in part upon the specialist advice of its broker. Where necessary, it may use more than one and there are many instances of a bank being able to contract out of losses as a result of a timely hint from contacts such as these. Not only do these brokers serve to bring the two sides of the market together, but they help to keep it healthy. Much the same facilities exist for the rediscount of hundis. When the Multani wishes to rediscount with a commercial bank, the facilities are usually arranged through a hundi broker. In other cases, the banks employ their own specialists for the purpose. Exchange transactions are arranged by exchange brokers, bullion purchases and sales by bullion brokers, and so on. The net result is a high degree of integration in the central money market and the establishment of a system of connections with parties and types of business far removed from the direct knowledge of the banks, which provide the ultimate accommodation. So that, within their own spheres of influence, the major Indian money markets, far from being under-developed as is so often assumed, provide ample evidence of a system of relationships quite as sophisticated as any found elsewhere.

The bazaar sections of the Indian money market also demonstrate a high degree of organisation. In general, the indigenous sector can be sub-divided into three main groups — Marwaris, Multanis, and Gujeratis (with the addition of Bengalis in Calcutta) — representing separate communities each with its own way of doing business. Nevertheless, some degree of homogeneity is secured, partly through the operations of the borrowers, and partly as a result of the somewhat tenuous connection with the commercial banks and other lenders. A large proportion of the resources of these indigenous banking groups is contributed from within their own communities and a measure of financial independence is the result. Indeed, it is this phenomenon which, together with the riskiness of the business undertaken, stands in the way of a more completely integrated system.

In these markets, usance or « muddati » hundis are the accepted credit instrument. Usually, they are drawn for a period of 90 days, but shorter usances are not uncommon. Frequently, the usance hundi is unaccompanied by any document of title to goods and, in these circumstances, may well be of an accommodation character only, but, as money is lent primarily on the personal credit and standing of the borrowers, this is not regarded as a serious defect. However, the Multanis do not lend for speculative purposes and deal only with genuine traders, whereas the Marwaris have no such inhibitions and even engage in speculation themselves. Rates of interest vary a good deal and certain merchants of standing are said to be able to borrow at between 3 and 5 per cent, but the more usual rate is 7 to 8 per cent from Multanis, an average of 9 per cent from Marwaris, and anything from 9 to 15 per cent from a Bengali.

The second main function of the indigenous banker is concerned with the collection of « darshani » hundis. The usance hundi is the instrument generally in use for borrowing

money, whereas the « darshani » hundi, or demand draft, is employed mainly for the collection of trade accounts or the remittance of funds. Two main types of transactions are involved. First, these hundis may have been drawn by merchants for goods supplied to traders in other centres. Supporting documents, such as railway or steamer receipts, may or may not be attached. Collection of what is essentially a demand bill is effected through the agency of an indigenous banker. Normally, one day's grace is allowed and, if the hundi is not paid, penalty rates are imposed. If it is not paid by the sixth day, the matter is taken up by a Darshani Hundi Committee, which certifies the fact of non-payment and takes disciplinary action by imposing further penalties. Second, such hundis may be drawn for the purpose of remitting funds from one centre to another. Thus, an established merchant operating in several centres may draw a hundi in one centre on his office elsewhere, discount it with an indigenous banker, who sends it for collection to the centre on which it has been drawn. Trade remittances through the banking system are always subject to a charge, but this is not invariably the case with the indigenous banker. It depends on the urgency of the need for funds. For example, in the busy season, frequently the shroff who is arranging the remittance will himself pay a commission to the party on whose behalf the funds are being transferred. In the slack season, either funds will be remitted without payment on either side, or a commission will be paid by the party requiring the transfer.

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Both in the central money markets and in the indigenous sectors different rates of interest will apply to the several types of business, mainly because of different degrees of risk. But, in addition to this phenomenon, it is not uncommon to find that the rates in different centres diverge significantly. For our purpose, it will be sufficient to analyse the comparative position in Bombay and Calcutta. In a fully integrated system, one would expect the rates in these centres to be approximately equal, since any tendency for rates to be higher in one should be met by an inflow of funds to take advantage of it and this would have the effect of reducing the disparity. But, in India, there are significant, if not considerable, divergences and it is therefore necessary to enquire into the possible causes. Some of these differences are rather puzzling. For example, both advance and bazaar rates in Calcutta tend to be higher than in Bombay, whereas with short-term money rates the position appears to be sometimes reversed.

The impression that lower average short rates rule in Calcutta appears to be mainly a statistical accident. Call money rates in Calcutta are governed by the Exchange Banks' Association, who agree to quote a relatively low rate. It is this rate which appears in the statistics. In actual fact, where the demand for finance exceeds moderate figures, money must be borrowed from banks outside the Association. Thus, at a time when the rate fixed by the Association is ½ per cent, a borrower might have to pay 1 or 1¼ per cent for a proportion of his money and this rate would equal — or even slightly exceed — that quoted in Bombay, where it seems that the published rates relate to an average of those charged by both the exchange banks and the larger Indian banks. The same considerations may also help to explain the published differences in 3 and 6 months deposit rates.

Rates on advances in Bombay approximate 2 to 5 per cent with the bulk of the business probably being done at 3 to 4 per cent in a moderately busy season. In Calcutta, the comparable range would seem to be 3 to 6 per cent, though some of the small banks (of which there are more in Calcutta) may do business up to 8 or 9 per cent. Most of the business seems to be done at 3 to 5 per cent. Hence, for many transactions, the effective rates are not greatly different, but the spread of rates over the whole field is undoubtedly greater in Calcutta and the average rate is significantly higher. Much the same is true of bazaar rates. Thus, between 1945 and 1949, the lowest bazaar rate reported in Bombay seems to have been 4½ per cent and the highest 8¼ per cent, with 7½ per cent the more usual upper limit. In Calcutta, the rate never fell below

6 per cent and the maximum was as high as 15 per cent, though 10 per cent would appear to have been more common. The following two seasons experienced rather exaggerated rates, due to special circumstances (the Korean War was one such influence), and the bazaar bill rate for February, 1952 was quoted at 9 per cent for Bombay, 10 to 12 per cent for Calcutta, and $13^1/_8$ per cent for Madras. By way of qualification, however, it should perhaps be added that, in comparison with Bombay, the Calcutta rate is more volatile and an average of all the rates which have ruled over a period would tend to be rather less different from the average ruling in Bombay than a range based on extreme movements would indicate.

It is not particularly difficult to discover reasons for the tendency for advance rates to be higher in Calcutta than in Bombay. In general, relatively higher rates in Calcutta can be analysed in terms of the respective importance of supply and demand factors. In the first place, Bombay is a more important banking centre, with larger banks and a greater concentration of head offices. Funds are in greater supply in Bombay, because bank reserves are held at the head offices and the larger the institution the larger the reserves, in addition to which the Reserve Bank itself has its head office there and, partly for this reason, open market operations (which, since 1945, have been undertaken on quite a substantial scale) tend to be concentrated in Bombay rather than in Calcutta (or Madras), so that there are greater facilities for the liquidation of securities at short notice. Not only is there still a large number of small banks in Calcutta, which are forced to pay higher rates in order to attract deposits and which charge correspondingly higher rates on advances (many of which constitute the more risky types of business), but the supply of money to the bazaar markets (where the divergence is more marked) is probably rather restricted, since the Bengali is not a « natural lender » and prefers to put his money into Government securities or land, where he judges the security of his investment to be greater (though it is true that the bulk of the lenders in the Calcutta bazaars are non-Bengali). An additional factor on the supply side is probably the relative weakness of the contacts between the indigenous and central money markets in Calcutta, where the rediscounting of hundis with the banks is not perhaps so highly developed as in Bombay. Since the link between the two sectors is the discounting shroff, the flow of funds between the two would tend to be less strong and a plentiful supply of « short » funds in the central market may have very little influence at the fringe and in the bazaars, where the rates rise steeply in times of stringency.

On the demand side also, there is reason to expect higher rates in Calcutta. The volume of trade is greater there and the demand for finance is highly concentrated, because of the larger number of important commodities dealt in and the overlapping of seasons. Jute, tea, and coal in particular absorb quite a lot of money. It is this which helps to explain the extremes to which interest rates can rise in Calcutta, though there are other, more psychological factors as well. It is also said that the emphasis on exports may help to explain the higher rates which obtain in Calcutta. Bombay, on the other hand, is primarily an import centre. It is argued that money is tied up longer in the export trade (particularly when goods are exported to Eastern countries), while import finance is said to liquidate itself fairly quickly. However, since most of the export bills are discounted in the London money market shortly after they have been drawn, this part of the explanation must be accepted with reserve. Indeed, the psychological factor would appear to be much more important. There are, for example, temperamental differences. The standard of business morality is higher in Bombay and, in general, the businessman there is more level-headed and less likely to gamble. It is sometimes said that the yields are higher in Calcutta and that business can afford to pay more, but one has the impression that much of this profit derives from speculation, which itself is a function of the ignorance of conditions which is so general in Calcutta markets. In short, much of the marginal demand for finance (which produces the extreme quotations) is absorbed in « fake » business. The high yields when they are obtained (which is not infrequently) must then be related to the heavy risks which are accepted by these businessmen and (for that matter) by some of the smaller banks which provide them with the funds.

On the basis of this analysis, therefore, it is not difficult to understand the structure of interest rates which obtains in India. Where rates are high, there is not the same incentive as in a more integrated system to transfer funds from centres (or sectors) where they are low. Frequently, the channels of communication are clogged or inadequate and the costs of transfer are too great. Moreover, costs must be measured in terms of convenience as well as in terms of money. For example, banks in Bombay may have funds to spare for a short period, but, in view of the costs involved and the uncertainty as to when they will need the funds themselves, they would be loath to transfer them to Calcutta to take advantage of higher rates there, so that although there is some movement of funds between the two centres, it is not nearly so general as might be supposed from first considerations alone. Moreover, it must be remembered that for similar classes of business the rates in the two centres are not greatly different and for those types of business for which high rates may be charged there are related risks, which the larger and better managed banks would be unwilling to accept.

In general, it is possible to sum up the position in India as a whole in much the same terms. For highly organised banking institutions doing substantially the same business, interest and other charges are not greatly dissimilar, differences being primarily due to costs of transfer of funds and variations in the degree of risk. By the same token, however, those markets which are not integrated with the more highly organised sections of the money market assume local characteristics, and charges are governed by particular considerations of supply and demand. The range of business done also varies more and the interest rate structure at the margin or « fringe » is governed by the somewhat restricted supply of finance for special purposes. This applies most obviously in the bazaar markets, but it is also apparent in the business done by some of the smaller banks. The funds available are restricted either to those from a special trading community or (as in the case of the smaller banks) to those who seek a high rate of return and are prepared to accept the consequential risks of loss. Charges to the borrower are correspondingly high. His will usually be a risky type of business, for the finance of which the larger concerns with a more conservative policy and (it should be added) less local knowledge will generally be unwilling to lend. Thus, functional specialisation does exist and many of these local and specialised markets are highly developed within their own sphere of activity. Where the development has been less complete is in the establishment of conventional relationships between markets, or groups of markets. In other words, the system is not yet fully integrated. Funds do flow both from one market to another and between similar markets in different centres, but the channels of communication are inadequate.