CHAPTER - ONE

INTRODUCTION

In a bank dominated financial system the study of the relationship between indicators of financial development and economic growth becomes a complex phenomenon due to the involved degree of imperfection. However, large no. of pioneer works has explained the relationship in a simple process of saving and investment by assuming that, bank as financial intermediaries accept deposits which constitute saving part and grants credit for investment. Cross country studies proves that greater involvement of banks in the process of resources mobilization through its prime function of accepting deposits and granting loan has produced positive effects on the productive assets of the economies. But, Long-term sustainable economic growth depends on the ability to raise the rates of accumulation of physical and human capital, to use the resulting productive assets more efficiently.

Early economists such as Schumpeter\(^1\) in 1911 identified banks’ role in facilitating technological innovation

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through their intermediary role. He believed that efficient allocation of savings through identification and funding of entrepreneurs with the best chances of successfully implementing innovative products and production processes are tools to achieve this objective. Some prominent scholars like Gurley and Shaw, Patrick, Goldsmith, and Mackinnon document appositive association between income levels and measures of financial intermediation through banks, and show that efficient intermediation contributes to economic growth in that it increases the volume of investment and improves resource allocation.

Recent contributions in ‘new’ growth theory Romer, P and Lucas and the literature on endogenous financial intermediation. Leland and Pyle, Diamond and Dybvig, Diamond, Bernanke and Gertler and Williamson have developed models which show that the large accumulation of physical and human capital in underdeveloped and developing economies are the outcome of intensive and extensive role of the banks in these economies.²

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The available literature support the facts that economies with better banking intermediation grows faster while inefficient banking intermediation bear the risk of growth deficit.

According to McKinnon, 3 liberalization of financial system allows financial deepening which reflects an increasing use of banking institutions which helps in the monetization of the economy, and allows efficient flow of resources among people and institutions over the time.

Monetization encourages savings and reduces constraint on capital accumulation and improves allocative efficiency of investment by transferring capital from less productive to more productive sectors.

Banking is typically the principal financial industry and has the potential to contribute the most or to most severely retard economic development in a country. A sound banking system always leads to balanced sectoral development of the economy through adequate deployment of credit to the various productive sectors.

Over the year’s credit, this in usual parlance had been seen as an important requirement of industrial and business enterprise. The demand for credit arises due to lack of simultaneity between the realization of income and act of expenditure either for direct consumption or for creating assets but, in all cases, it depends on potential.

Noted economist Schumpeter⁴ says, ‘The necessary command over productive factors is provided by monetary claims in the form of credit.’ Credit is form of newly created purchasing power for Schumpeter. Credit would mean a net increase in money supply; banking, through its credit creation activity, enhance the money supply.

Thus, review of the literatures indicates that, the better functioning banking intermediation ease the external financing constraints that impede firm and industrial expansion, and foster the rate of the economic growth.

In a typically bank-dominated financial system as India is, bank plays vital role in ensuring long run growth of the economy by mobilizing financial surplus from net savers to deficit

⁴ Theory of Economic Growth and Technical progress; an introduction, Bakul H Dholakia and Ravindra H Dholakia, Macmillan India Ltd. 1998,(P 39-40)
spenders. However, the process of mobilizing this surplus has being questioned when some specific regions of the economy has not benefited in same proportion as their contribution in generating these surplus. The state like Bihar, where net savers has saved more but the deficit spenders has borrowed less witnessed a technical problem of lowest C D ratio in the state and continued till the date, resulting into poor capital formation, lesser productivity, lower per capita income, and most important loss of conducive environment for further business activities.

In Bihar situation is critical in deployment of credit by largest group of financial intermediaries of the Indian economy, even with sufficient reasons and resources for credit deployment in the state. As on end march, 2005 the state of Bihar occupies nearly, 5.6 percent, a significant part of Indian banking network and contributes 2.3 percent in its total deposit amounting at ` 41007 cr. While aggregate size of credit was stood at ` 12869 cr. The aggregate size of credit deployed by banks in the state is abysmally lower than the size of sectoral credit deployed in some states like Gujarat, Karnataka, Rajasthan, Madhya Pradesh, Punjab, Haryana, and Delhi. But, comparison of the market size of these states with the market size of Bihar tells different story.
As per white paper\textsuperscript{5} on state finance by the government of Bihar in 2006, market size of Bihar is 4.8 percent of the market size of all India, more than that of the market size of Punjab, Haryana, Delhi and, Madhya Pradesh and little less than that of the market size of Rajasthan, Karnataka, and Gujarat. Poor credit deployment in the state has adversely affected the economy of Bihar. The State has registered poorest rate of growth during the most of the years of reform decades, ranging from extreme low, -1.6 to 5.5 percent per annum.\textsuperscript{6}

Thus, a known ignorance by established ‘agency for development’ i.e. commercial banks has left a poor state on its own fate. However, initiatives taken by these agencies may ensure adequate credit deployment to the various sectors of the state so, that, the state of Bihar will stand in the row of developed states of the country.

Poor C D ratio and its consequences is not a newly observed phenomenon for the state; \textsuperscript{7} in fact the state has witnessed the said phenomenon in its past also so, considering it

\textsuperscript{5} White paper on state finance and development; Finance Department, Government of Bihar, December, 2005 (P, 36-37)
\textsuperscript{6} Economic Survey of Bihar (2006-2007), (P 2-5), computed.
\textsuperscript{7} Bihar Economy Through The Plans; in comparison with All-India and other states- K N Prasad, 1997(P, III-5)
a factor retarding growth of the state, several initiatives has been taken to improve it at all possible levels, but situation is still out of control. During my study I have realized that the problem of low C D ratio has now converted into the problem of poor C D ratio since, the state has witnessed poorest, 20.7 percent of credit deposit ratio in March, 2001 with outstanding credit of Rs 5547.2 crore.

During the same period the national average was 56.7 percent with outstanding credit of Rs 538433.8 crore. So, the state has recorded merely, 1.03 percent of aggregate credit deployed by commercial banks across the country. The situation became more vulnerable in March, 2007 with state’s share of 0.9 percent in total outstanding credit of the country.

The historic research work primarily focus on the cause and effect of low C D ratio in a specified period of 1991-2007. During my research, I have confronted with some specific situations like, division of the state of Bihar and changed methodology of calculating C D ratio in 2005.8

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Division of the year of 2000 was peculiar in some aspect; it has changed not only the geography or polity of the states, but it has also changed the nature of the economy. Changed setup and priorities of both (Bihar and Jharkhand) the states has also affected the scope for lenders as well as borrowers.

**Research methodology, Hypothesis and Objective:**

Research is an intellectual activity primarily based upon existing information, assumptions, knowledge, and practices. It is used to establish or confirm facts, reaffirm the results of previous work, solve new or existing problems, support theorems, or develop new theories. However, the primary purposes of research are determined by its nature, which are of two types.

1. Basic research, and
2. Applied research.

As opposed to applied research basic research are documentation, discovery, interpretation, or the research and development of methods and systems for the advancement of human knowledge, where as applied research is associated with.

Like, the nature of research, there are several areas of working viz, commercial, behavioral, scientific, and academic where positive contribution can be made through a potent
research work. The presented research work is applied in nature, and will prove its significant contribution in the literature of economics as well as in the area of policy formulation for the well being of mankind.

- **Research methodology:**

  The used research methodology is inductive and experimental in nature where experimentation refer to that process of research in which one or more variables are examined under the conditions which permit the collection of data which shows the cause and effects. Selection of inductive method for research has made me enable to utilize my understanding of local circumstances.

  The used data are secondary, which are collected from both, published and unpublished sources. Apart from this, facts are also collected through personal interaction with bankers, government officials, traders, entrepreneurs, farmers, officials and experts of prominent agencies like RBI and NABARD.
Objective of the study:

Considering the important role of C D ratio in the development process of the state of Bihar, and pursuant to the direction from supervisor of this historical work, I have set the following objectives.

1. To analyze the concept, significance, and the degree of effectiveness of credit deposit ratio in the literature of Economics,

2. To examine the existing banking support and performance of the banks in deployment of credit in the state of Bihar,

3. To examine the performance of SBI in the state,

4. To determine the cause and effect of the problem of low C D ratio in the state of Bihar, and

5. To suggest measures, this could be implemented to improve the situation.

Hypothesis formulation:

A hypothesis is proposed explanation for a phenomenon. Before, conducting any research a researcher has to assume something positive or negative about the things, situations or phenomenon, which in turn becomes the genesis for the hypothesis formulation by the researcher or the group of
researchers. However, the process and nature of the hypothesis formulated varies as per the area of working.

In the discipline of social sciences the formulated hypothesis for conducting a research may depend upon observations, assumptions, facts, human behavior, trends of social science indicators, and most important economic indicators.

The presented research work is also the testing of formulated hypothesis based upon the observation and review of related literatures regarding the existing relationship between one of the important banking indicators, called C D ratio and the state of the economic development of a backward state like Bihar. The formulated hypothesis for this historic study is ‘working hypothesis’ in its nature: A ‘working hypotheses’ is a hypothesis which is provisionally accepted as a basis for further research.

Thus, on the basis of personal understanding, observation of debates and discussion by experts, academicians, researchers, parliamentarians, legislative members, business delegates, industrialists, traders and farmers, the presented study set and test the following hypothesis.
1. Poor C D ratio leads to inter regional and interstate variation in credit deployment,

2. Poor C D ratio of a underdeveloped region or a underdeveloped states indicates fly of disposable income in the form of saving to the other developed states or developed regions,

3. Problem of low C D ratio in Bihar is the result of long ignorance of the state and its potential, and

4. Poor C D ratio in the state is perpetuating itself and creating obstacles in the realization of the potential of the state which in turn degrade the economic development of the state of Bihar.

Apart from the above mentioned basis of hypothesis formulation; related news published in news papers, review of literatures especially report of task force, working group, and views of expert panels on C D ratio, guidelines of supervisor and other faculty members of the department of Economics has helped a lot in hypothesis formulation.
REVIEW OF LITERATURE

To make the study scientific and historic in nature there is need of vigorous effort accompanied by reliable sources of information and literatures. During my study I have also gone through some selected and useful literatures relating to the nature and requirement of the work. Brief information of used literature is given here.

1. Economic Development Problem, Principle, and Policies, Benjamin Higgins, Universal Book Stall, 1998: the book is discussed about general move towards a more interdisciplinary approach to development problems with widening and deepening of interest in the political, socio-cultural, and psychological aspects of development. Author of this book emphasized that the chief barrier to economic development is still our ignorance of the process.

2. Growth Divergences; Explaining Differences in Economic Performance, edited by: Jose Antonio Ocampo, Jomo K S, and Rob Vos, Orient Longman in association with United Nations 2007: the united nation world economic and social survey 2006 was on the theme of diverging growth and development. To prepare for the survey, over a dozen background paper was commissioned. One of the papers by
Valpy FitzGerald has pointed out about financial development and economic growth. According to the paper both are clearly related. However, the channels and even the direction of causality have remained unresolved in both theory and practices. Nonetheless, strong causality from particular forms of financial institution to rapid economic growth has recently become a central axiom of economic theory, strengthened by apparent support from empirical cross countries studies of the relationship between the indicators of financial development and observed rate of growth. Specifically, greater financial depth would be associated with higher level of productivity, and thus income per capita and higher level of development would be associated with a more advanced financial structure, involving evolution from bank to non bank financial intermediaries and from both of these to stock markets.

3. Growth and Development with Special Reference to Developing Economies, A P Thrilwal 7th Edition Macmillan 2003: this book combines description and analysis, with an emphasis on the elaboration of simple and useful theoretical economic models for an understanding of the issues that comprises the subject matter of development economics. Apart from the theoretical discussion of classical, neo classical, and ‘new’ endogenous growth theory, this book also focuses on
financing the development from the domestic sources with the better use of banks.


5. Capital market the Indian financial scence. N Gopalsawmi Macmillan India ltd, 2005: capital markets are barometers of the economy. The author of this book has presented a nice idea of the role of capital market in resources mobilization. The book also discussed about the present rules and regulation related to financial intermediaries working in India.

6. Harvesting Despair- Agrarian Crisis in India, Members of perspective team, January, 2009: this is the collection of field studies report conducted by group of students and teachers of Delhi University, and J N U. This book helps us to understand the agrarian crisis, its nature, cause, and consequences in a live way.
7. India: Monetary Policy, Financial Stability And Other Essays, Academic Foundation by C Rangrajn, 2010: The book is divided into four sections: Monetary Policy and Fiscal Issues; Growth and Development; Sectoral Issues - Industry, Power, Banking and Agriculture; and External Sector and Globalization


Keynes considered public credit (i.e. government compensatory borrowing and spending and World Bank lending operations) as a sine qua non of both domestic stable, growth
and international economic development, while at the same time favouring a 'cheap money' policy as a helpful stimulant to vigorous investment in the long run. Schumpeter, on the other hand, regarded private credit as one of the strategic variables in economic development, as an indispensable adjunct to entrepreneurship and innovation. In the light of these monetary insights of Keynes and Schumpeter book explore the monetary role in economic development. Specifically the concerned chapter will discuss the functional relationship among credit, interest and growth.

Apart from the study of books, journals, research papers, and monograms I have also gone through some specific literatures on C D ratio in the form of reports and recommendations. Some of the important committee and their recommendations are as given below.


Under the set objective of the task force, the task force had done tremendous exercise and identified the reasons behind
low C D ratio in then Bihar and suggested important steps to overcome the problem.

The task force had identified some basic problem behind low C D ratio. Some of the important are:

- Inadequate banking infrastructure and staff,
- The A C P prepares by banks covers large no of account with low volume of credit,
- Absence of backward and forward linkage in the state,
- High incidence of industrial sickness,
- Absence of land records,
- Migration of capital for investment in Bihar is taking place which is not reflected in the C D ratio of the state,
- Poor recovery performance of banks, and
- Lack of institutional backup for entrepreneurial development.

The task force has not only identified the reasons behind lower C D ratio of state but also suggested all possible way to overcome the problem. Prior to suggesting the action and steps the task force had also considered the suggestions and recommendations of earlier committees on the same, like Sen committee of 1984, Ojha committee of 1986, the C D R
monitoring committee of 1986, and the high level working groups of SLBC-1990. Some of the selected suggestions by these committees including the Selvam committee are listed below.

- Creating awareness by suitable publicity measures,
- Identification of entrepreneurs,
- Mass loaning for crop production,
- Development of minor irrigation,
- Identification of constraints,
- Review of existing industrial units,
- A system of quick disposal of application,
- Introduction of new technologies,
- Establishment of linkage,
- Empowering the RRBs,
- A continuous search of identification of unexplored areas and activities.

Credit Delivery system in Bihar 2005 (A consultancy study report); This report is prepared at the request of Rural Planning and Credit Delivery Department of Reserve Bank of India Mumbai by professor S Nandi (Professor, Business Environment Group, IIML) and associate professor M Jayadev, (Finance and Accounting Group, IIML). The study group has submitted it report
in 2007 to RBI, Mumbai. The report focuses on the existing credit delivery system of Bihar. In its report the joint study group has opined that credit to deposit ratio (CD ratio) of Bihar state is consistently lower than the national average and stood as challenge for bankers and policy makers. In spite of introduction of a series of supply side measures the credit-deposit ratio of Bihar has not improved and it is hanging in the range of 20 to 25 percent against national average of around 58 percent.

Bihar is a symbol of non-development and stagnation in India and it is no longer confined to the boundaries of the state. After the formation of Jharkhand that has been created out of the state of Bihar, the situation and the performance of banks both in terms of deposits and advances has been low. The qualitative analysis and discussions with bankers and borrowers shows that, banks are well equipped with all types of infrastructure facilities to do lending but due to lack of viable credit proposals; the credit demand is very poor and sluggish.

2. Report of the working group to look into the problems faced by bankers and borrowers in Bihar, RBI, Mumbai, August 2006: the seven member working group was constituted by RBI on the advice of M O F, Government of India vide its letter DO:RPCD:CO:LBS NO. 982/02.05.02/2006-2007 under the chairmanship of Mr. V S Das (Executive Director, RBI). The RBI
has constituted this working group after the meeting with SLBC, Bihar chaired by Union Finance Minister and was attended by C M and Dy. C M of the state of Bihar. The WG has set its following main objectives.

- To review the matters related to KCC and SHGs in Bihar,
- Efforts made by bankers in the area of recovery of bad loans,
- To review the bank performance in Government sponsored programmes in the state, and most important
- To probe the case of zero lending by some bank branch in the state.

The WG has covered all the 38 districts of the state and visited, 539 branches of SCBs working in the state at that time. Before the submission of the report the WG has also considered the findings and suggestions of the group of the Bankers of Bihar set up by RBI, Patna office in 2003. Thus after a long exercise the WG has submitted its report to the RBI, Mumbai, and opined that, “the performance of the banks working in the state has been below expectation, as reflected in the form of lower C D ratio and poor recovery of loan in the state. So the concerned
institutions must take the problem of low C D ratio as a serious challenge for the state.

3. Annual reports of state level bankers committee (SLBC Patna): The State Level Bankers' Committee (SLBC) has been envisaged as a consultative and co-ordination body of all financial institutions operating in each state. The Committee is expected to discuss issues, consider alternative solutions to the various problems in the field of banking development and evolve a consensus for co-ordinate action by the member institutions. In Bihar State Bank of India is convener bank for SLBC.

4. Methodology of calculation of C D ratio at various levels, recommended by Mr. Y S P Thorat, (M D, NABARD) committee. The committee was appointed by ministry of finance, Government of India in 2003. The committee has submitted its report to the Government of India in 2005. With slight modification in suggestions of the committee Government of India has accepted the recommendations and implemented it with the help of RBI. As per new guidelines C D ratio is calculated by banks at three levels and the fund disbursed under RIDF scheme is also considered for calculating C D ratio.

member’s taskforce was appointed by Government of India under the chairmanship of Shree S C Jha. After the close observation, debate and discussion the taskforce opined that, Bihar's exposure to the banking services is very limited and hence, per capita availability of financial services in Bihar is considered to be lowest in the country. To push Bihar on sustained economic growth momentum, there is an urgent need to expand the base of financial services, with a particular focus on the rural economy and the small and medium entrepreneurs. The expanded financial services must be cost effective and their delivery should be of high quality.

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