CHAPTER - TWO

BANKING AND ECONOMIC DEVELOPMENT

Theoretical Considerations:

One of the major debates in financial economics pertains to the role of banks in the process of economic development through financial intermediation. According to Fama, in an ideal world of complete and perfect capital markets with full and symmetric information, there is no role for banks and financial intermediaries. Hence, one has to answer first the question as to an unintermediated one. There are two ways by which financial intermediaries can improve on unintermediated markets is.

1. By reducing search costs, and

2. By reducing transaction costs.

Without intermediation, savers will have to search for suitable investors and similarly investors will have to look for suitable sources of funding. By engaging an intermediary, agents can cut across costs of duplicating searches and can reap

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economies gained by financial intermediaries which specialize in such search activity. Similarly, financial intermediaries can also reduce transaction costs by reducing the number of transactions required and by offering standardized products.

Financial intermediaries can also help to reduce monitoring costs. There are certain assets whose value can be realized by investing a certain amount of time and effort for monitoring their performance. The existence of monitoring costs gives another reason why an intermediary can improve on the outcome of an unintermediated market.

It has also been argued that intermediaries can also reduce verification costs. The value of an asset to its owner depends on how he invests his time and effort into monitoring and verifying its performance. A financial intermediary is often better placed to ensure verification of value of asset without much duplication.

Thus, individuals instead of spending time and money to verify the value of assets can entrust this job to an intermediary which possesses economies in undertaking such tasks. Financial intermediaries also provide instruments that allow for diversification and hedging of risks, thereby allowing economic agents to utilize resources efficiently.
The Basic Economic Function of Commercial Banks

According to Dr. C Rangrajan, the basic economic function of bank intermediation can be summarized as follows.

1. "Liability-Asset transformation i.e., accepting deposits as a liability and converting them into assets such as loans;

2. Size transformation i.e., providing large loans on the basis of numerous small deposits;

3. Maturity transformation i.e., offering savers alternate forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities; and

4. Risk transformation i.e., distributing risk through diversification which substantially reduces risk for savers which would prevail while lending directly in the absence of financial transformation”.

Financial intermediaries like banks are unique and specialize in performing some special functions such as;

1. Mobilizing savings and channeling them to most productive uses, and

2. Acting as efficient conduit for payments.

10. Innovations in banking, the Indian experience C Rangrajan 1997 (P. 18-19).
Role of Commercial Banks

Regarding the role of banks, there are divergent views in the literature. According to the ‘old’ view, commercial banks are ‘unique’ among financial institutions. This is in contrast to the views of the ‘new’ school which considers commercial banks as ‘pure’ of passive intermediaries i.e., they act like brokers rather than creators of loanable funds. In other words, according to ‘pure’ view, banks are not Independent source of net addition to aggregate spending.

There is a growing body of literature regarding the credit view of the monetary transmission process, which attributes to financial intermediaries like banks, a key role in the transmission mechanism of monetary policy. In recent years, the issue of how monetary policy affects the level of financial intermediation or the credit channel has attracted a great deal of attention. This key role in monetary transmission process emanates from banks’ position as an interface between monetary authorities and the non-bank private sector.

According to Fama\textsuperscript{11} borrowers will have to pay higher rate (return) for unintermediated debt than intermediated debt, as
for some borrowers’ bank credit is ‘special’ i.e., they are not perfectly substitutable for bonds. The main argument of Fama 12 for bank intermediated debt (credit) is that banks have comparative advantage in gathering information about borrowers. In view of the importance given to banks in the theoretical literature as well as in practical consideration i.e. impact of monetary policy on growth through banking platform, because banks are designed in such a way that policy makers can attained the targets so, it would be appropriate to analysis the role of banks in the Indian context.

**Banking in the Indian Context**

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. But the banking industry’s potential performance is constrained by the monetary policies of the central bank, Government policy, and most important bankers’ attitude towards itself.


In the case of India, the central bank, Reserve bank of India, has been very successful in providing a strong financial environment for the nation. Within this environment, indeed, perhaps because of it, the nation's banking sector is performing relatively well on global risk front.

It should not be surprising that India has a strong banking sector given the financial deepening that has taken place, especially over the past 20 years. Nonetheless, the progress in financial sector development was seriously supported by the government policy of nationalization of major private sector commercial banks in 1969 and 1980 to provide directed credit on favorable terms to productive sectors.

During the planning periods banks became prime source of finance for our five year plans mainly after establishment of social control on banks. Even, during the first decade of Green Revolution, the regions enjoyed more of Green Revolution, where banking facilities were relatively better than those potential areas of Green Revolution where banking facilities was not up to the mark. Banks, as a platform for implementing monetary policy as well as facilitating agencies for government sponsored self employment programmes has helped lot to our country.
Over the last six decades, the conduct of monetary policy in India has undergone sharp transformation and the present mode of monetary policy has evolved over time with numerous modifications, with new institutional arrangements, changes in the policy framework, objectives, targets and instruments of monetary policy.\(^{13}\)

Based on the policy framework, broadly two distinct regimes can be delineated in the monetary policy history of India, since Independence.

- The first regime refers to the credit-planning era followed since the beginning up to the mid-1980s.

- The second is the regime started with adoption of 'money-multiplier' framework, implemented as per recommendations of Chakravarty Committee.

The post-Chakravarty Committee regime also can be separated into two sub-periods distinguished by the event of economic reforms of 1991-92. There was a radical shift from direct to indirect instruments and emergence of a broad, deep and diversified financial market, with prevalence of greater autonomy, in the post-reform period.

\(^{13}\) Monetary Management and Institutional Reform; S S Tarapore, UBS Publishers, 2001(P-112)
In the process of reforms, the interest rate structure was rationalized in the banking sector and there is greater emphasis on prudential norms. Banks are given freedom to determine their domestic term deposit rates and prime lending rates (PLRs), except certain categories. The developments in all the segments have led to gradual broadening and deepening of the financial market and therefore creating a favorable environment for economic development.

These developments had significant implications for financial deepening of the economy. During this period the growth of financial assets was faster as compared to the growth of output. The volume of aggregate deposit of scheduled commercial banks increased from Rs 4,338 crore in March 1969 to Rs 60,596 crore in March 1984 and Rs 26,969,376 crore in 2006-2007. The volume of bank credit increased from Rs 3,396 crore to Rs 41,294 crore and Rs 24,769,366 crore, respectively particularly, non-food credit increased from Rs 3,915 crore in March 1970 to Rs 37,272 crore in March 1984 and Rs 18,524,965 crore in 2007-2008.

This period also witnessed growing volume of priority sector lending, which had not received sufficient attention by the commercial banks prior to nationalization. The share of priority sector advances in the total bank credit of scheduled commercial
banks raised from 14 per cent in 1969 to 36 per cent in 1982 and it is 35%. The share of medium and large industries in the bank credit had come down from 60.6 per cent in 1968 to 37.6 per cent in 1982. During this period, monetary policy of the RBI mainly focused on bank credit, particularly non-food credit, as the policy indicator. Basically, the attention was limited to the scheduled commercial banks, as they had high proportion of bank deposits and timely available data.

Among the policy instruments, SLR was mainly used to serve the purpose of raising resources for the government plan expenditure from the banks. The level of SLR had progressively increased from the statutory minimum of 25 per cent in February 1970 to 36 per cent in September 1984 and again 25 % in 2007-2008. SLR has served the economy epically during the period of high non plan expenditure. The total investment by schedule commercial banks in government securities was Rs 798387 crore in 2007-2008 while GDP of India during same year was Rs46,93,602 crore.

Now a day’s, banks’ investment in government securities is prime source for government flagship programmes, creating infrastructure or employment in the economy. Banks has provided funds through standing facilities such as 'general
refinance’ and ‘export refinance’ to facilitate developmental financing as per credit plans. The instrument of CRR is mainly used to neutralize the inflationary impact of deficit financing.

**Role and Importance of Bank Credit**

A sound banking system always leads to balanced sectoral development of the economy through adequate deployment of credit to the various productive sectors while Smooth and sufficient credit availability to these sectors largely governed by credit policy adopted by central monetary authority. 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 Schumpeter\(^{14}\) 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,

\(^{14}\) Theory of Economic Growth and Technical Progress by Bakul H Dholakia and Raindra H Dholakia, Macmillan India Ltd. 1998, (P, 34-36)
through its credit creation activity, enhances the money supply.” However, for an agrarian economy credit is not only newly created purchasing power but, it provides origin for the transformation of ‘subsistence’ based agrarian society to ‘surpluses based agrarian society.

**Bank Credit and Rural Economy**

Credit, as one of the critical non-land inputs, has two-dimensions from the viewpoint of its contribution to the augmentation of agricultural growth viz., availability of credit (the quantum) and the distribution of credit. Since independence the total institutional credit supply to agriculture sector has increased from 7.3% in 1951 to 61.1% in 2002 however it was reaches up to 66.3% in 1991. The total mountained institutional outstanding amount to agriculture sector was Rs 1, 80,486 crore in 2005-2006.

- **Priority Sector Lending**

  The RBI also identified certain sectors – agriculture and allied activities and small-scale and cottage industries – as ‘priority sectors’ in 1972 and introduced the concept of Priority

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Sector Lending. In 1979, it directed all banks to lend 40 per cent of their loans to these sectors.

The total allocation to priority sector was stood at Rs 5,09,910 crore in 2005-2006, which is about 36% of total bank credit. However, RBI has also made provisions for the difference amount of 4% under RIDF scheme for infrastructural development of rural areas especially in the area of agriculture and allied activities.

- **Rural Infrastructure Development Fund (RIDF)**

  The key feature of the scheme (RIDF) started in 1995-1996, is that it is a demand-driven non-concessional lending facility to Governments, Government agencies, NGO, PRI bodies, fully funded by scheduled Indian commercial banks from the unlent portion of their prescribed minimum requirement for priority sector lending.\(^\text{16}\)

  In general, there is robust empirical evidence of positive effects’ of RIDF investment through financial intermediation. However, literature on rural growth established

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that positive growth and poverty eradication is outcomes of investment in rural infrastructure. This has also reflected the weak link between urban economic growth and rural poverty reduction in India.

Rural infrastructure in particular, coming predominantly through public investment, has been shown to improve agricultural productivity, lower rural poverty, and improve competitiveness and employment in the rural sector. However, studies also reveals some important facts that the private sector has been invited to finance, implement and manage public utilities and evolve commercially viable pricing schemes but private sector involvement may not be practicable for rural infrastructure in the foreseeable future.

A large component of infrastructure, such as rural roads, has the classical characteristics (non-excludable, non-rival) of a public good, so that cost recovery is only possible indirectly via tax revenues generated through the growth impact. Direct recovery through user charges is possible in some sectors like irrigation, but can face constraints on pricing imposed by compliance considerations so; Government attention is expected in these areas and off course, the schemes like RIDF can reduce the financial strain from the Government.
Since its inception in 1995-1996, the RIDF has made significant contribution in terms of rural infrastructure development. The total corpus cumulates to Rs. 28500 crore, slightly over one percent of current nominal GDP in 2002-03. So for irrigation potential to the tune of 117.84 lakh hectare has been created at all India level.

Recurring employment to the tune of about 64,16,010 man days has been created in rural areas. Non-recurring employment in irrigation sector to the tune of about 1,736 million man-days has also been generated by the end of March 2007.

The value of incremental production from investment in irrigation has been estimated at about ₹13,539 crores during 1995-2007 periods. In terms of sectoral allocations, Irrigation and Road Sector got the major share of the fund.

Investment on roads and irrigation are estimated as having the largest impacts on productivity growth and rural poverty reduction. Investment on roads had a bigger impact on poverty than any others., roads were found have contributed significantly to the growth of agricultural output and fertilizer use

17. Working paper on RIDF by Indira Rajaraman. NABARD, Annual Report 1999-00
and also to bank expansion. For a given bank density and other infrastructure, the direct effect of roads on private investment was found to be mixed, suggesting that the major effect of roads is not via their impact on private agricultural investment but rather on marketing opportunities and reduced transaction costs of all sorts.

It was found that the cropping intensity on the farms of the respondents for whom farming is the vocation as also a source of livelihood in the project area of Chhattisgarh was 121.4% before the construction of roads. The same increased to 133.9% after the roads and bridge had been built.

In the same area, household has recorded compound 3% annual growth in income due increased availability of employment in nonfarm sectors. Besides tangible benefits there is number of intangible benefits. These benefits include better access to primary health facilities, girls’ education, etc.

Agencies report shows that small farmers benefit from infrastructure that promotes activities like milk production and floriculture, and that large farmer’s benefit from infrastructure that supports producing and marketing of field crops.
It was observed that the agricultural and other credits significantly went up after the implementation of the RIDF projects. It emerges that building of rural infrastructure helps in making the local area credit worthy and so also the borrowers by reducing the risk of income generation and increasing the collateral land value.

**Bank Credit and Industrial Sector**

The industrial sector typically contributes more dynamically to overall output growth, because of its potential higher productivity growth, which results from increasing returns to scale and gains from innovations and learning-by-doing. Manufacturing’s greater dynamism is also derived from its capacity to forge greater vertical integration among different sectors of the economy by processing raw materials and intermediate industrial inputs.

However, these dynamics itself depends upon banking and its products, especially designed for corporate or for some specific industrial units. At the time of independence India had only traditional commercial bank that was willing to fund the working capital requirement of only creditworthy borrowers on the security of tangible assets.
The situation changed significantly after nationalization and financial sector deregulation of 1991. Banks started term lending in a big way with the help of low cost deposit funds. In these changing process development financial institutions has lost its protective policy climate.

DFIs, thus found it difficult to remain viable by rising fund from market and compete with commercial banks. Therefore, the DFIs started withdrawn themselves from corporate finance, some DFIs like ICICI and IDBI, remerged as commercial banks.

➢ **Corporate Borrowing and Commercial Banks**

Although the Indian corporate sector raises a large part of their financial requirement through bank loans, there has been increasing reliance on the debt and equity markets, so commercial banks, to meet their demands gradually diversified into several new areas of business like merchant banking, mutual fund, leasing, venture capital, loan syndication and other financial services. Further, in India (like US) banks may lend to the companies through commercial paper route on an average 25% of commercial paper are purchased by commercial banks.
An empirical investigation\textsuperscript{18} of 4332 listed companies during 1998-2005, reveals that the volume of debt owned by an average company increased significantly over the time from Rs 264.13 crore to Rs 655.53 crore, a nominal increase of 150% over a 7 years period. Over the same periods, bank debts on the book of an average company increased from Rs 29.88 crore to Rs 64.45 crore a nominal increase of 116%. Inter corporate debt owed by an average company rose from Rs 0.99 crore to Rs 1.88 crore.

The ratios of bank debt and inter corporate debt to total debt of an average company do not exhibit this monotonically increasing relationship with respect to time. The ratio of bank debt to total debt is much larger in magnitude, indicating that about a third of the debt incurred by an average Indian company is owed to banks.

The upsurge in the ratio of bank credit to total debt since 2003 may also be accompanied by declining performance of NBFCs and amendment in company act which sets limit for inter corporate borrowing.

\textsuperscript{18} Impact of monetary policy on corporate borrowing in India by Suman Kumar (Brunel University, UK.) and Sudipa Majumdar (ICRA, India)
Bank Credit and MSMEs

In a nation’s economy, it’s the small and micro enterprises which play a vital role. For, they not only give employment to a large number of unskilled and semi-skilled people but also support bigger industries by supplying raw material, basic goods, finished parts and components, etc.

The critical role and place of the MSME sector in the Indian economy in employment generation, exports and economic empowerment of a vast section of the population is well known. There are about 2.6 crore enterprises in this sector. The sector accounts for 45 per cent of the manufactured output and 8 per cent of the Gross Domestic Product (GDP). MSMEs contributed close to 40 per cent of all exports from the country and employ nearly 6 crore people which is next only to the agricultural sector. MSME is the best vehicle for inclusive growth, to create local demand and consumption. MSMEs cater to niche markets. The MSMEs of yesterday are the large corporate of today and could be MNCs of tomorrow.

MSMEs primarily rely on bank finance for a variety of purposes including purchase of land, building, plant and machinery as also for working capital, etc. Availability of timely
credit at reasonable rates is the need of the sector. However, banking support was not sufficient to these sectors due to some technical reasons, may be characterized as structural problems. But, after the enactment of ‘Micro, Small and Medium Enterprises Development Act, 2006.’ Banks has taken serious efforts, advances extended to the MSMEs sector are treated as priority sector advances and as per the extant Reserve Bank guidelines, banks are required to extend at least 60% of their advances to the MSMEs sector to Micro Enterprises.

As at the end of March 2009, the total outstanding credit provided by all Scheduled Commercial Banks (SCBs) to the MSE sector was Rs. 2,56128 crore, constituting 11.4 percent of the Adjusted Net Bank Credit. Credit flow to MSMEs had therefore, doubled from Rs 1,27,000 crore in 2006-07 to Rs 2,57,000 crore in 2008-09.

➢ **Bank Credit and Personal Finance**

In the present economic system commercial banks have proved its supportive role from all aspect. For agriculture and allied activities it provides most scarce, non factor inputs called formal credit, where as for manufacturing and cooperates it provides liquidity and credibility in the form of bank guarantee.
Besides, now the commercial banks are playing more vital role than earlier for households.

In the era of high individual inspiration and physical society, banks are not only the place for net saving by households but, these are converted into such kind of institution which are helping individual’s to fulfill its dream and needs. Bank supported credit card facilities, consumer loans, car loan, housing loan, medical emergency loan, marriage and education loan all has created a supportive wavier for great consumer class of the country.

Available data on household saving and credit behavior shows that during the period of 1991-2009, there is consistently high growth in deposit and credit. Individual’s share in total household deposit is around 79 percent while credit avail by them is about 39 percent. The credit deposit ratio maintained by over all household is 47 percent which is quite good for a developing country like India. Proportion of long term credit amount has increased from 42 percent in 1996 to 67 percent in 2009.

According to NSSO report (1998 and 2002) on household credit behavior, 57.1 percent of total household of the country have access to formal source of credit in 2002, out of which 24. 5 percent was the share of commercial banks; however,
the percentage share of commercial banks (33.7 percent in 1992) has declined because of increasing role of NBFIs and NBFCs.

Thus, banks have played vital role in economic growth and development through it’s the role of financial intermediaries, not only in particular region or state but very well manner, in those economies where capital market accessibility is very limited and restricted. The role of commercial banks especially government sector banks are unchallengeable in growth and development.

Over all, an important empirical finding based on cross-country data of 43 developing countries (including India) between 1970 and 1990, found that a unit increase in the ratio of current bank investment (net of interest) to total bank investment increases the per capita real GDP growth rate by 0.05 percentage points.19