Economic milestone and a poignant anniversary

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"Bank nationalisation eased rural credit and aided financial inclusion. Any move to reverse it would be self-defeating."

The nationalisation of banks in 1969 was a watershed moment in the history of Indian banking. From July 19 that year, 14 private banks were nationalised; another six private banks were nationalised in 1980. It is certain that one cannot locate a similar transformational moment in the banking policy of any country at any point of time in history.

At the time of Independence, India's rural financial system was marked by the domination of landlords, traders and moneylenders. In 1951, if a rural household had an outstanding debt of ₹.100, about ₹ 93 came from non-institutional sources. From the 1950s, there were sporadic efforts to expand the reach of the institutional sector, particularly in the rural areas. Despite these measures, the predominantly private banking system failed to meet the credit needs of the rural areas.

Class to mass banking

India's banking policy after 1969 followed a multi-agency approach towards expanding the geographical spread and functional reach of the formal banking system. First, as a part of a new branch licensing policy, banks were told that for every branch they opened in a metropolitan or port area, four new branches had to be opened in unbanked rural areas. As a result, the number of rural bank branches increased from 1,833 (in 1969) to 35,206 (in 1991). Second, the concept of priority-sector lending was introduced. All banks had to compulsorily set aside 40% of their net bank credit for agriculture, micro and small enterprises, housing, education and "weaker" sections. Third, a differential interest rate scheme was introduced in 1974. Here, loans were provided at a low interest rate to the weakest among the weakest sections of the society.

Fourth, the Lead Bank scheme was introduced in 1969. Each district was assigned to one bank, where they acted as "pace-setters" in providing integrated banking facilities. Fifth, the Regional Rural Banks (RRB) were established in 1975 to enlarge the supply of institutional credit to the rural areas. Sixth, the National Bank for Agriculture and Rural Development (NABARD) was constituted in 1982 to regulate and supervise the functions of cooperative banks and RRBs.

The outcomes of such a multi-agency approach were admirable. The share of institutional sources in the outstanding debt of rural households increased from just 16.9% in 1962 to 64% in 1992.

Growth spurring

India's nationalisation experience is an answer to mainstream economists who argue that administered interest rates cause "financial repression". According to this view, if the government administers interest rates, the savings rate would decline, leading to a rationing of investment funds. On the contrary, India's nationalisation led

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to an impressive growth of financial intermediation. The share of bank deposits to GDP rose from 13% in 1969 to 38% in 1991. The gross savings rate rose from 12.8% in 1969 to 21.7% in 1990. The share of advances to GDP rose from 10% in 1969 to 25% in 1991. The gross investment rate rose from 13.9% in 1969 to 24.1% in 1990.

Nationalisation also demonstrated the utility of monetary policy in furthering redistributionist goals. Some economists argue that banks cannot be used to right "historical wrongs". On the other hand, India's nationalisation shows that monetary policy, banks and interest rates can be effectively used to take banks to rural areas, backward regions and under-served sectors, furthering redistributionist goals in an economy.

A retreat

Yet, strangely, arguments in favour of financial liberalisation after 1991 were based on the theory of financial repression. The Narasimham Committee of 1991 recommended that monetary policy should be divorced from redistributionist goals. Instead, banks should be free to practise commercial modes of operation, with profitability as the primary goal.

Taking the cue, the Reserve Bank of India allowed banks to open and close branches as they desired. Priority sector guidelines were diluted; banks were allowed to lend to activities that were remotely connected with agriculture or to big corporates in agri-business, yet classify them as agricultural loans. Interest rate regulations on priority sector advances were removed.

The outcomes were immediately visible. More than 900 rural bank branches closed down across the country. The rate of growth of agricultural credit fell sharply from around 7% per annum in the 1980s to about 2% per annum in the 1990s. This retreat of public banks wreaked havoc on the rural financial market. Between 1991 and 2002, the share of institutional sources in the total outstanding debt of rural households fell from 64% to 57.1%. The space vacated by institutional sources was promptly occupied by moneylenders and other non-institutional sources.

A to and fro

The government and the RBI probably saw the danger coming. In 2004, a policy to double the flow of agricultural credit within three years was announced. Only public banks could make this happen. So, in 2005, the RBI quietly brought in a new branch authorisation policy. Permission for new branches began to be given only if the RBI was satisfied that the banks concerned had a plan to adequately serve underbanked areas and ensure actual credit flow to agriculture. By 2011, the RBI further tightened this procedure. It was mandated that at least 25% of new branches were to be compulsorily located in unbanked centres.

As a result, the number of rural bank branches rose from 30,646 in 2005, to 33,967 in 2011 and 48,536 in 2015. The annual growth rate of real agricultural credit rose from about 2% in the 1990s to about 18% between 2001 and 2015. Much of this new provision of agricultural credit did not go to farmers; it largely went to big agribusiness firms and corporate houses located in urban and metropolitan centres — but recorded in the bank books as "agricultural credit". For this reason, the share of institutional credit in the debt outstanding of rural households in 2013 stood at 56%, still lower than the levels of 1991 and 2002. Yet, in achieving the high growth of credit provision, the expansion of public bank branches was pivotal.

After 2005, public banks also played a central role in furthering the financial inclusion agendas of successive governments. Between 2010 and 2016, the key responsibility of opening no-frills accounts for the unbanked poor fell upon public banks. Data show that more than 90% of the new no-frills accounts were opened in public banks. Most of these accounts lie dormant or inactive, but it is unmistakeable that the fulfilling of the goal required the decisive presence and intervention of public banks. The same public banks were also India's vanguard during the global financial crisis of 2007 when most markets in the developed world, dominated by private banks, collapsed.

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However, despite such a stellar track record, the macroeconomic policy framework of successive governments has hardly been supportive of a banking structure dominated by public banks. In times of slow growth, the excess liquidity in banks was seen as a substitute for counter-cyclical fiscal policy. Successive governments, scared of higher fiscal deficits, encouraged public banks to lend more for retail and personal loans, high-risk infrastructural sectors and vehicle loans. Here, banks funded by short-term deposit liabilities were taking on exposures that involved long-term risks, often not backed by due diligence. Unsurprisingly, many loans turned sour. Consequently, banks are in crisis with rising non-performing assets. The same fear of fiscal deficits is also scaring the government away from recapitalising banks. The solution put forward is a perverse one: privatisation. The goose that lays golden eggs is being killed.

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Nationalization of banks

Why in the discussion?

- On July 19, 50 years of nationalization of 14 major banks of the country have been completed. Most of the country's big banks were involved in this step taken in the national interest. Those were operated by the private sector. The nationalization of these banks by the then government is one of the stringent decisions taken in the area of financial inclusion and social reform.
- In today's issue, we will understand what was its background? What was the reason for nationalization of banks? What was the purpose and what has been the benefit? Also we will understand what the negative effect of nationalization has been and what is the current situation?

What is the background?

- In fact, even after independence, in the name of banking system most of the traditional system like money lender and Mahajan existed. They used to provide loans to the citizens as per the requirement, but there were more cases of interest rates and fraud on them, due to which many anomalies were caused in the society, which has effects like educational, social and economic backwardness even today.
- According to a data, before the nationalization of banks, only 14 banks had 80 percent of the total capital of the country, while due to lack of proper regulation and control, small banks were going bankrupt, in which the money of the deposited citizens was sinking. Neither the government nor the bank was taking responsibility for those money of the citizens of the country.
- According to the data, in the short period from 1947 to 1955, more than 350 banks of the country were drowned, along with the money of the citizens deposited in it. For example, these banks, instead of becoming the axis of socio-economic development of the country, were causing social and economic discrepancies. In addition, the financial situation of the government was weakened by the India-China war in 1962 and the India-Pakistan war in 1965.

What was the purpose of nationalization?

- This step of the then government of the time was in accordance with the ideals and values of the constitution of the country because the bankruptcy of more than 350 banks in the early phase of independence was not good for the economic health of the country, as well as driven by the private sector. Due to this, the government was not in control of them.
- Therefore, the aim of the government was to make them accessible in rural areas through control of banks, through which credit and agriculture can be increased and investment can be increased in the agricultural sector.

What happened?

- The objective of nationalization of banks has been largely successful as their branches have increased after the nationalization of banks, as well as expanding their service sector.

- In the year 1969, where there were only 8322 branches of banks in the whole country, in 1994, this number increased to around 60 thousand. Therefore, the nationalization of banks proved to be a major success in the field of socialist development and financial inclusion of the constitution and government.
- Also, due to the establishment of public control over the banking sector, a professional approach was adopted in it and due to the loan to agriculture and small industries, a new class of entrepreneurs developed in the country, which gave employment to people and increased their purchasing power.

Negative impact

- The nationalization of the country's banks took place at different times, in which the name of Imperial Bank was changed to State Bank of India in the year 1955, and in 1959, the associate banks of SATHP were nationalized, but in 1969 the nationalization of those 14 big banks Happened, whose deposits were more than fifty crores.
- After this, when the banks were nationalized again in 1980, the number of borrowers in the country increased. The reason for this was that the loan taking process and rules were simplified.
- As a result of this, their non-performing assets started to increase as banks had lack of experience as well as a decline in the debtor's tendency to repay the loan.
- As far as the current situation is concerned, the government has raised six banks. It has announced to recapitalize 70 thousand crore rupees in the budget 2019-20 to overcome the problem of. It is evident that this step taken by the government reflects the importance of banks in the economy.

Expected Questions (Prelims Exams)

1. Consider the following statements-

1. 14 Banks were nationalized in 1969.
2. Bank nationalisation was done to facilitate rural loan and financial inclusion.

Which of the above statements is/ are correct?

(a) Only 1 (b) Only 2

(c) Both 1 and 1 (d) Neither 1 nor 2

Expected Questions (Mains Exams)

Q. Nationalization of Banks facilitated rural loan and financial Inclusion. To what extent privatization of banks will be adequate as a new solution for the increasing problem of Non-Performing assets.

(250 Words)

Note: Answer of Prelims Expected Question given on 8 Aug. is 1 (c)