50 Years of Nationalization of Banks

This article is based on the editorial **"The 1969 bank nationalization did India more harm than good"** that appeared in The Livemint on 17th July 2019. It critically analyses the nationalization of banks.

50 years ago, the Indian financial sector underwent a tectonic shift, when Indira Gandhi government nationalized the 14 biggest commercial banks in 1969. According to many economists nationalization of banks was the single-most-important economic policy decision taken by any government after 1947. The impact of this decision is considered by some to be, even more than the economic reforms of 1991.

During that time many Asian countries were switching to more market-oriented policies, India on the other hand, supported the socialist policies.

However, with the looming banking crisis in current times, debates have emerged about the privatisation of banks. This raises the question of whether nationalisation of the bank in the first place was the right move or not.

A Brief History of Nationalization

- In 1955, India nationalized Imperial Bank of India with extensive banking facilities on a large scale, especially in rural and semi-urban areas.
- It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State governments all over the country
- On 19th July 1969, a major process of nationalization was carried out and 14 major commercial banks in India were nationalized.
- The second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with six more banks.
- This step brought 80% of the banking segment in India under Government ownership.

What factors led to the nationalization of banks?

- After independence, the Government of India (GOI) adopted planned economic development for the country. Nationalisation was in accordance with the national policy of adopting the socialistic pattern of society.
- Nationalization came at the end of a troubled decade. India has suffered many economic as well as political shocks.
    - There were two wars (with China in 1962 and Pakistan in 1965) that put immense pressure on public finances.
    - Two successive years of drought had not only led to food shortages but also compromised national security because of the dependence on American food shipments (PL 480 program).
    - Subsequently, a three-year plan holiday affected aggregate demand as public investment was reduced.
    - The decade of 1960-70s was the lost decade for India as the economic growth barely outpaced population growth and average incomes stagnated.
    - Industry's share in credit disbursed by commercial banks almost doubled between 1951 and 1968, from 34% to 68% whereas agriculture received less than 2% of total credit.
        - Agriculture needed a capital infusion, with the initiation of the Green Revolution in India that aimed to make the country self-sufficient in food security.
- Other reasons responsible for the nationalization of banks were-
    - **Social welfare**
    - **Controlling private monopolies**
    - **Expansion of banking to rural areas**
    - **Reducing regional imbalance** to curb the urban-rural divide
    - **Priority Sector Lending:** In India, the agriculture sector and its allied activities were the largest contributors to the national income.
    - **Mobilization of savings:** Nationalisation aimed at mobilizing the savings of the people to the largest possible extent and to utilize them for productive purposes.

What were the benefits of nationalization?

- After the nationalization of banks, the branches of the public sector bank India rose to approximately 800% in deposits and advances took a huge jump by 11,000%.
- Banking under government ownership gave the public implicit faith and immense **confidence about the sustainability of the banks.**
- Banks were no longer confined to only metropolitan or cosmopolitan in India. In fact, the **Indian banking system has reached even to the remote corners of the country.**
    - This is one of the main reasons for India's growth process, particularly in the Green revolution.

    - Purpose of nationalization is to promote rapid growth in agriculture, small industries and export, to encourage new entrepreneurs and to develop all backward areas.
- Public deposits in the bank have increased so much that leaving it completely to the private sector might pose a challenge.

    Banks, by advancing loans to the speculators and non-priority sector, have created havoc in the economy.

Balance of payment crisis 1991 started an era of liberalization, privatization and globalisation. However, the political control of bank lending continued even after the 1991 reforms which today had culminated into the bad loan or Non Performing Assets crisis that has slowed down India's growth trajectory.

Was the nationalization of banks a right move?

- NPA crisis since 2012 is at least partly explained by the credit bubble that grew under political patronage that emerged out of government's control over Banks.
- Nationalization of banks led to an interest rate structure that was incredibly complex.
    - There were different rates of interest for different types of loans. The Indian central bank eventually ended up managing hundreds of interest rates.
    - This defeated the purpose of nationalization, as due to complex structure loans never reach the needy ones.
- Banking is a highly competitive enterprise which works on profits, nationalization of banks has led to lesser competition between the public sector and private sectors banks.
    - This has created a bureaucratic attitude in the functioning of the banking system.
    - Lack of responsibility and initiative, red-tapism, inordinate delays are common features of nationalized banks.
- **Although liberal credit policy is necessary for providing financial support to the weaker sections of the rural community, such a policy may prove harmful for the stability of the banking system.**
    - The experience of the nationalized banks has shown that these banks are now facing the problems of heavy overdue loans and economically unviable branches.
    - Extending loans to agriculture and small scale industries is risky and less remunerative. Such loans are against the sound banking rules and may weaken the economic viability of these institutions.
- Due to lack of performance audit of banks, policy-making failed to ensure that the finance from the public institutions are, in fact, going to productive uses in the large public interest

Given the significance of a vibrant banking system in the growth story of the nation, privatisation of banks is proposed. However, privatisation of banks is not a panacea. India must not make haste in going for the privatisation of banks, rather it must focus on comprehensive governance reforms, resolution of NPAs and creating a free market so that investment can be reinvigorated and wheels of the economy can again get back on track.

Drishti input

The nationalization of banks in 1969 has done more harm than good to the Indian economy. Comment?