Creating a Central Bank for India

‘Central banks . . . must be quick to adapt their methods to suit the changing economic structure . . . they must be perspicacious and versatile.’  R.S. Sayers (1948)

‘where banking habits touch only a minor part of the economy, the contribution that a central bank can make to development is more important than what it can do in the way of stabilization’.  Ursula Hicks (1962)

RATIONALE OF CENTRAL BANKING

Keynes’s pioneering contributions to the theory and organisation of central banking were made in the course of the prolonged discussions of the case for establishing a central bank for India. They are all the more remarkable considering his total lack of practical exposure to central banking, which unlike any other branch of macroeconomics, requires a uniquely complex amalgam of institutional as well as theoretical knowledge. Keynes had no formal connections with any central bank, except for his short and rather nominal stint as a Director of the Bank of England during the last five years of his life (1941–6). The nearest he came to any assignment as adviser to any central bank was in 1920 when he was approached by General Smuts to visit South Africa for two months to assist in formulating monetary policy and drafting legislation for a central bank. Keynes could not accept the invitation due to other commitments. Instead, he recommended Henry Strakosch who, together with Arthur Gillet, later drafted the legislation to establish a central bank for South Africa. 1 Again in 1920 Keynes was requested by Smuts to serve on a selection committee with Strakosch, to choose a Governor for the new South African Reserve Bank. Keynes, while agreeing to serve, wrote later to Smuts that ‘it is a difficult post to fill, and well qualified candidates are scarce; but we met yesterday and there are good prospects, I think, of a strong appointment (CW, XVII, pp. 200–201). Eventually, W. H. Clegg (a Bank of England official born in Bloemfontein,
Creating a Central Bank for India

South Africa) was appointed to the post. The South African episode is instructive as the only recorded instance of Keynes being approached to formally advise on the creation of a central bank.

Keynes thought and wrote extensively on central banking in his *Indian Currency and Finance* and later in the course of his work as a member and/or as an expert witness for successive Indian Currency Commissions and committees (1913–26), the Macmillan Committee in England (1929–31) and in the second volume of his *Treatise on Money (The Applied Theory of Money*, 1930) which contains the first systematic analytic and comparative discussion of central banking.

Keynes’s involvement in central banking matters derived from his strong interest, as an essentially policy-orientated monetary economist, in the development of an appropriate institutional framework for the effective and efficient operation of the monetary system in India, notably to ensure the elasticity of the note circulation in the busy season in India, the centralised management of the foreign reserves, and the development of a widely ramified commercial banking system and the popularisation of cheque payments. Keynes rightly perceived that it was not meaningful to make monetary policy prescriptions without a clear prior formulation of the institutional framework of central banking and of the transmission mechanism of monetary and credit policy. The scope and limitations of the instruments of central banks are determined by institutions and the nature of the transmission mechanism. However, in assessing Keynes’s contributions to the development of central banking in India it should also be borne in mind that India has had a long history of several abortive attempts to set up a state banking institution with some elements of a central bank, although that term was not specifically used. The earliest recorded scheme to establish an institution in India with some characteristics of a central bank was the Plan for a General Bank in Bengal and Bihar (at that time the main British territories in India) prepared by Warren Hastings (Governor – later Governor-General – of Bengal) in January 1773 and placed before the Board of Revenue. This Bank, which was set up in April 1773, proved to be a very short-lived project. Between this and Keynes’s initial ideas on central banking in India there were a number of infructuous schemes.

Keynes’s ideas on central banking in India are spread over the various sections on the case for the establishment of a central bank for India in his *Indian Currency and Finance* (pp. 41–2, 114, and 164–8); his comments on Lionel Abrahams’s memorandum as well as