REPORT OF THE COMMITTEE TO REVIEW THE WORKING OF THE MONETARY SYSTEM

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BOMBAY

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PREFACE

The Committee to Review the Working of the Monetary System was appointed, in December 1982, by the then Governor, Reserve Bank of India, Dr. Manmohan Singh and was asked to review the functioning of the monetary system in India. Members were chosen in their individual capacity as eminent men, each distinguished in his own field of specialisation.

Terms of reference given to the Committee were wide. These necessitated a close look into virtually all aspects of the monetary system. These also required a careful review of the relevant policy issues bearing in mind especially the need for long-term changes. Analyses and policy recommendations which have been reached by the Committee unanimously are incorporated in this Report.

In discharging this obligation, I have been greatly benefited by the time and advice given generously by all members of the Committee. In particular, I should like to mention the great help that I have received from Dr. C. Rangarajan in discharging my responsibility and also from his advice as an expert in technical problems of monetary economics.

Finally, it is my most pleasant duty to express my sincere thanks to Dr. J. C. Rao, Secretary of the Committee, who has shown exemplary dedication to the task that was assigned to him. His analytical acumen, extreme hard work and ability to synthesize complex findings, analytical and statistical, should not go unrecorded here.

On behalf of the members of the Committee and on my own behalf I would like to express my sincere thanks to Dr. Manmohan Singh, former Governor, and Shri R. N. Malhotra, Governor, for their support and advice.

Sukhamoy Chakravarty

Chairman

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Chapter 1 : INTRODUCTION

As the functioning of the monetary system in India had not been the subject of any comprehensive review the Reserve Bank of India appointed a committee in December 1982 to undertake such a review of the working of the monetary system and suggest measures for improving the effectiveness of monetary policy as an instrument for promoting the basic objectives of planned economic development. Various working groups and committees appointed by the Reserve Bank of India and Government of India in the past have, however, examined over the years specific areas of the monetary system. It was therefore possible for a newly appointed committee to undertake an in-depth study of the working of the monetary system drawing upon the work of these earlier working groups and committees and also by undertaking a detailed investigation on its own of issues that are relevant to the working of the monetary system as a whole.

1.2 The Committee to Review the Working of the Monetary System was constituted under the chairmanship of Prof. Sukhamoy Chakravarty and consisted of the following :

1. Prof. Sukhamoy Chakravarty	Chairman
2. Shri M. P. Chitale	Member
3. Dr. R. K. Hazari	Member
4. Dr. F. A. Mehta	Member
5. Dr. C. Rangarajan	Member

1.3 The Committee was given the following terms of reference :

(a) To critically review the structure and operation of the monetary system in the context of the basic objectives of planned development.

(b) To assess the inter-action between monetary policy and public debt management in so far as they have a bearing on the effectiveness of monetary policy.

(c) To evaluate the various instruments of monetary and credit policy in terms of their impact on the credit system and on the economy. In this context links among the banking sector, the non-banking financial institutions and the unorganised sector could be assessed.

(d) To recommend measures for improvement in the formulation and

operation of monetary and credit policies and to suggest specific areas where the various policy instruments need strengthening.

(e) To make such other recommendations as the Committee may deem relevant to the effective operation of monetary and credit policy.

1.4 Initially, the Committee was given time upto June 30, 1984, to submit its report. However, taking into account the amount of work involved its term was extended upto April 30,1985.

1.5 Having regard to the wide terms of reference, certain key areas which required to be studied in depth were chosen and special studies in these areas were assigned to experts (Annexure 1.1). Besides these, the Secretariat to the Committee also took up studies in some of the areas having relevance to the terms of reference.

1.6 In order to elicit the views of all concerned in a common format which facilitated the detailed analysis of different views and comments, four sets of questionnaires covering the areas of monetary policy, banking, industry and trade, and public debt were prepared and sent to the commercial banks, co-operative banks, government departments, financial institutions, industry and trade organisations, academicians and others requesting them to give their comments and suggestions (Annexure 1.2). The questionnaires were despatched during August-October 1983.

1.7 After the receipt of replies to the questionnaires, the Committee had discussions with representatives of various organisations and banks (Annexure 1.3). The Committee greatly benefited from such discussions and we would like to express our thanks to them for their co-operation. The Committee met the then Governor, Dr. Manmohan Singh who was kind enough to spare considerable time for the Committee to discuss a number of major issues being examined by the Committee. The Committee also took the opportunity of inviting some of the senior officers of the Reserve Bank to its meetings to discuss specific issues. We thank them for their co-operation and for their useful suggestions. In all, the Committee held 37 meetings over a period of more than two years.

1.8 The Committee would like to thank all those who gave detailed comments and suggestions in their replies to the questionnaires issued by the Committee, as also those who otherwise conveyed their useful suggestions to the Chairman and other members of the Committee.

1.9 We would like to thank the various scholars who readily agreed to our request to prepare studies on selected topics related to the terms of refe-

rence. These studies mostly cover new ground and hence their research efforts should be of particular interest to the academic community interested in the field of monetary economics.

1.10 We are happy to place on record our deep appreciation of the excellent support we have received from the Secretary Dr. J. C. Rao, and other members of the Secretariat of the Committee (Annexure 1.4). They have worked with great dedication and put in a considerable amount of effort in producing useful notes relevant to the various chapters in our Report and in compiling and analysing a vast amount of statistical data, apart from attending to the usual secretarial functions in a most efficient manner.

1.11 The Secretariat received the utmost co-operation and useful guidance from the various departments of the Reserve Bank, and in particular the Department of Economic Analysis and Policy which also provided most of the staff of the Secretariat apart from extending excellent administrative support. We, therefore, wish to convey our very special thanks to the Reserve Bank in this regard. We thank the Computer Centre of the Department of Statistical Analysis and Computer Services for providing expert programming assistance and prompt execution of computer runs in regard to the econometric studies undertaken by the Secretariat. Our thanks are due to the Reserve Bank also for all the facilities provided to the Committee for the discharge of its responsibility.

Chapter 2: PLANNING AND DEVELOPMENT

With the objective of achieving rapid economic and social development of the country, the democratic planning process was initiated in April 1951 with the launching of India's First Five Year Plan. The central objective of planning in India as enunciated in the First Five Year Plan was to "initiate a process of development which will raise the living standards and open out to the people new opportunities for a richer and more varied life".[1] Accordingly, the main objectives of planning which have been emphasised in varying degree over the successive Five Year Plans have been growth, social justice, self-reliance, alleviation of poverty, modernisation, and improvement in productivity. The objectives of alleviation of poverty and reduction in inequalities in incomes and wealth have acquired greater importance in recent Plans.

2.2 Attainment of high productivity and expanding levels of production which are basic to economic and social development can be achieved only by stepping up the rate of capital formation, improving the technical efficiency of capital and upgrading labour skills. It was, hence, recognised that economic and social development was a long-term process and the speed of such development depended on the success achieved in bringing about desired changes in the social and economic organisation.

2.3 At the commencement of planning in 1951, the Indian economy was operating at relatively low levels of saving and investment. The First Five Year Plan noted that in an under-developed country like India with low levels of standard of living and rapidly increasing population, the desirable growth rate in output can be achieved only if the rate of capital formation could be stepped up over the years substantially above the level of 10 per cent of gross domestic product observed in 1950–51. Organisational and institutional changes for raising the rate of domestic saving have, therefore, been receiving considerable attention in the successive Plans.

2.4 The planning strategy over the years has been based on the concept of a mixed economy, in which both the public sector and the private sector had a role to play. The public sector was assigned a growing role in regard to investment activity, notably in the development of infrastructure and selected basic industries. It was also to play a significant role in the field of mobilisation of resources.

1. The First Five Year Plan (Planning Commission, Government of India) p.7.

2.5 We note with interest the role assigned to monetary policy and credit policy, as early as in the First Five Year Plan, in regard to allocation of resources and price policy. The First Five Year Plan recognised the role of prices as a factor in determining resource allocation in a mixed economy but emphasised that the direction of investment need not solely be guided by profit considerations. Nevertheless, the Plan also cautioned that "the relationship between costs and returns even in the public sector has to be judged, at least as a first approximation, in terms of market prices."[2] Further, it was stressed that the structure of prices should be such that the resultant allocation of resources was consistent with the targets defined in the Plans. The aim of economic policy should accordingly be to bring about such a price structure. During a period of increasing pace of development it was inevitable that the structure of prices undergoes a change and the overall price level moves up. However, if the level of incomes rises and so long as there are no adverse distributional effects, some degree of price rise during the development process could be tolerated. The First Five Year Plan postulated that financial as well as physical controls were necessary as a part of price policy, since price policy was "partly a problem of allocation of resources and partly a question of ensuring reasonable equality of sacrifice among the different sections of the people."[3]

2.6 Accordingly, the First Five Year Plan emphasised the role of monetary and credit policy as an important instrument for maintaining price stability and for regulation of investment and business activity. The increasing volume of production and trade in the economy cannot be sustained without expansion in the supply of money and credit and therefore the supply of money has to respond to the increasing volume of transactions in the economy. The First Plan document stated: "This must come about through extension of credit institutions which will impart the necessary elasticity to money supply without generation of inflationary pressures."[4] It was postulated that the growing credit needs of agriculture and industry, particularly cottage and small scale industries, had to be met through a larger network of credit institutions which will mobilise savings in the rural areas and disburse credit on a large scale. In the initial stages, credit creation in anticipation of generation of savings might become necessary to give a 'push' to production. To quote from the First Plan document, "judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part

2. The First Five Year Plan (Planning Commission, Government of India) p.36.

3. Ibid., p.37.

4. Ibid., p.38.

to play, for, it is conceivable that without this kind of initial push the upward pressure may not start at all or may fail to gather momentum."[5] The Reserve Bank was, therefore, expected to play its part in furthering economic development along agreed lines by aligning the banking system to the needs of a planned economy.

2.7 As economic development progresses the monetary system would be called upon to meet the financial needs of growing economic activities. This would bring in its wake organisational and structural changes. The task of the central bank would not then be confined to mere regulation of the overall supply of credit. It would also include creation of the machinery needed for financing developmental activities in the country and for ensuring that the finance made available flowed in the desired direction. In this context special credit facilities to high priority sectors became necessary.

2.8 It is clear that the operation of the monetary system should be consistent with the priorities laid down in the Plans so that the process of mobilisation of savings and utilisation of these resources becomes 'socially purposive' as rightly emphasised in the First Five Year Plan. In the following paragraphs we review briefly the progress achieved under the Plans in regard to raising the level of output, and changing the structure of the economy, and against this background we draw attention to the implications of the planning effort to the pursuit of monetary and credit policy.

2.9 During 1951-52 – 1983-84 the growth rate of real national income, on a semi-log trend basis was 3.5 per cent per annum, of agricultural production 2.6 per cent per annum, and that of industrial production 5.3 per cent per annum. Population grew at a compound rate of 2.2 per cent per annum during this period. The rate of growth in per capita real income was, hence, of the order of 1.3 per cent per annum during the period 1951-52 – 1983-84. The growth rates of national income and agricultural and industrial output during different Plan periods are shown in Table 1, these being computed on an average annual basis.

2.10 The growth in output achieved over the Plan periods was accompanied by notable structural shifts in the composition of output. Although agriculture continues to be the major production sector, its share in gross domestic product (GDP) declined from 59.0 per cent in 1951-56 to 38.2 per cent during the Sixth Five Year Plan (first four years). The share of industry (mining, manufacturing and construction) rose from 14.7 per cent to 21.1 per cent during the same period. The share of infrastructure (electricity, gas, water supply, transport, storage and communication)

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5. The First Five Year Plan (Planning Commission, Government of India) p.38.

(per cent per annum)

	Net National Product (at factor cost, at 1970-71 prices)	Agricultural Production	Industrial Production
First Five Year Plan 1951-52 – 1955-56	3.6	4.2	6.5
Second Five Year Plan 1956-57 – 1960-61	4.1	4.3	6.9
Third Five Year Plan 1961-62 – 1965-66	2.4	–1.1	7.6
Annual Plans 1966-67 – 1968-69	4.1	6.8	1.6
Fourth Five Year Plan 1969-70 – 1973-74	3.4	3.1	3.3
Fifth Five Year Plan 1974-75 – 1978-79	5.3	4.5	5.7
1979-80	–5.5	–15.2	1.2
Sixth Five Year Plan 1980-81 – 1984-85 (first four years)	5.5	7.7	4.8
1951-52 – 1983-84 (33 years)	3.7	3.4 *	5.5
1970-71 – 1983-84 (14 years)	3.8	3.4 *	4.7
Semi-log Trend			
1951-52 – 1983-84	3.5	2.6 *	5.3
1970-71 – 1983-84	3.8	2.6 *	4.7

Note : The growth rates have been computed as averages of annual growth rates unless otherwise specified.

* The considerable difference between the average annual growth rate and the semi-log trend in the case of agricultural production may be noted.

Sources : Computed from annual data published in National Accounts Statistics (Central Statistical Organisation, Government of India), and Economic Survey (Ministry of Finance, Government of India).

Table 2 : Composition of Gross Domestic Product
(at 1970-71 prices)

(per cent)

Plan Period	Agriculture and Allied Sectors	Mining and quarrying, Manufacturing and Construction	Electricity, Gas, Water Supply, Transport, Storage and Communication	Others	Total
First Five Year Plan 1951-52 – 1955-56	59.0	14.7	4.0	22.3	100.0
Second Five Year Plan 1956-57 – 1960-61	55.5	16.8	4.6	23.1	100.0
Third Five Year Plan 1961-62 – 1965-66	49.5	20.1	5.5	24.9	100.0
Annual Plans 1966-67 – 1968-69	46.0	21.4	6.3	26.3	100.0
Fourth Five Year Plan 1969-70 – 1973-74	45.9	21.1	6.5	26.5	100.0
Fifth Five Year Plan 1974-75 – 1978-79	43.3	21.4	7.5	27.8	100.0
1979-80	38.8	22.4	8.4	30.4	100.0
Sixth Five Year Plan* 1980-81 – 1984-85	38.2	21.1	8.6	32.1	100.0

* First four years

Source : Averages for Plan periods are computed from annual data published in National Accounts Statistics (Central Statistical Organisation, Government of India).

increased from 4.0 per cent of GDP in 1951-56 to 8.6 per cent. The remaining components of GDP which accounted for 22.3 per cent of GDP in 1951-56 formed about one third of GDP in the Sixth Five Year Plan (first four years). Changes in the composition of GDP on the basis of the above categories according to Plan periods are presented in Table 2.

2.11 There has been a marked change in the industrial structure as a result of the shift in production from traditional agro-based industries to chemicals and engineering industries as can be seen from Table 3.

Table 3 : Industrial Structure

Sectoral weights (per cent)

Manufacturing Sector	1956	1960	1970
Food	15.7	14.2	9.5
Textiles	47.0	31.9	21.5
Rubber, Chemicals and Petroleum	11.7	12.9	18.2
Non-Metallic Minerals	2.8	4.5	4.1
Basic Metals	10.4	8.7	10.9
Engineering	8.3	19.7	25.9
Others	4.1	8.1	9.9
Total Manufacturing*	100.0	100.0	100.0

* Does not include mining, quarrying and electricity sectors of the Index of Industrial Production.

Source: Sixth Five Year Plan (Planning Commission, Government of India).

2.12 A major transformation has also taken place in the industrial organisation with the growth and development of the public sector. The average share of the public sector in GDP increased from 8.5 per cent during the First Five Year Plan period (1951–56) to 23.2 per cent in the first four years of the Sixth Five Year Plan (1980-85).

2.13 A crucial factor which has influenced the rate of growth in output achieved under the Plans is the incremental capital-output ratio. There has been a rise in the incremental capital-output ratios, particularly during the Third and Fourth Plan periods, but during the Fifth Five Year Plan the ratio declined sharply as seen from Table 4.

Table 4 : Estimates of Incremental Gross Capital-Output Ratios (ICORs) (at 1970-71 prices)

Plan	Period	ICOR
First Five Year Plan	1951–56	3.2
Second Five Year Plan	1956–61	4.1
Third Five Year Plan	1961–66	5.4
Annual Plans	1966–69	4.9
Fourth Five Year Plan	1969–74	5.7
Fifth Five Year Plan	1974–79	3.9

Source: Sixth Five Year Plan (Planning Commission, Government of India).

2.14 Trends in the rate of saving and investment since 1950–51 are shown in Table 5. There has been a substantial rise in the rate of saving from 10.2 per cent of gross domestic product in 1950–51 to 22.6 per cent in 1983–84. During the same period, the rate of investment in the economy was stepped up from 10.0 per cent to 23.9 per cent and was financed primarily out of domestic savings. The reliance on foreign sources which constituted 3.2 per cent of GDP in 1960–61 has since come down to 1.8 per cent of GDP or less in the Eighties.

Table 5 : Rates of Gross Domestic Saving and Capital Formation

Year	As per cent of GDP at current market prices	
	Gross Domestic Saving	Gross Domestic Capital Formation
1950–51	10.2	10.0
1955–56	13.9	14.3
1960–61	13.7	16.9
1965–66	15.7	18.2
1970–71	16.8	17.8
1975–76	20.0	19.9
1980–81	22.9	24.6
1981–82	22.1	23.9
1982–83	22.8	24.4
1983–84	22.6	23.9

Source: National Accounts Statistics (Central Statistical Organisation, Government of India). Data for 1983-84 are Quick Estimates.

2.15 Mobilisation of savings and the deployment of these resources among different sectors of the economy according to Plan priorities, are

key elements in the process of developmental planning. There has been a remarkable growth in the accumulation of savings by households over the last thirty years. These savings account for the bulk of domestic savings, the contribution of the public sector and the private corporate sector being relatively small. A notable feature of the savings behaviour of the household sector is the increased preference of the households to hold savings in the form of financial assets such as bank deposits, life fund, and provident funds. Household savings in the form of financial assets as a proportion of net household savings have increased from 36.4 per cent in 1951-56 to 54.2 per cent in 1980-84.

2.16 The rapid growth of the household savings in the form of financial assets has been brought about by diversified growth of the financial system in India. In particular, the various promotional measures undertaken by the banks under public ownership have helped in the mobilisation of savings of the households. There has been both a widening and a deepening of the financial structure over the Plan periods. With the growth of the money and capital markets, the degree of financial intermediation has increased and this has also helped to channel the growing volume of household savings in the form of financial assets into diverse productive activities in the public and private sectors. The promotion of development banks and term lending institutions by the government with the active association of the Reserve Bank has helped both the public sector and the private corporate sector to bridge their resource gap to a considerable extent.

2.17 Although the financing of the successive Plans was facilitated by greater mobilisation of savings, there has been a disconcerting inflationary trend in the economy over the years. The First Five Year Plan witnessed a moderate decline in prices. Inflationary pressures started building up from the commencement of the Second Five Year Plan. The average annual rate of change in the wholesale price index (base 1970-71 = 100) during different Plan periods is given in Table 6.

2.18 The prices of agricultural commodities rose sharply in years when unfavourable weather conditions brought about a steep fall in agricultural output. Apart from this factor, the oil shock has significantly contributed to the rise in the domestic price level during the Seventies. The management of aggregate demand and supply balance has therefore assumed increasing importance over the years in the context of the Plan objective of growth with reasonable price stability. While we shall be examining these factors later on in the Report, the experience of the last three decades clearly indicates that measures aimed at augmenting the supplies of key commodities and constraining the growth of liquidity in the economy through various monetary and fiscal policies have an important role in ensuring that reasonable price stability is maintained.

Table 6 : Rate of Change in the Price Level * (per cent)

Period	Average annual change in the price level
First Five Year Plan	- 2.7
Second Five Year Plan	6.3
Third Five Year Plan	5.8
Annual Plans (3 years)	8.1
Fourth Five Year Plan	9.0
Fifth Five Year Plan	6.3
1979–80	17.1
Sixth Five Year Plan @	9.3
1951–52 – 1984–85@	6.2
1951–52 – 1970–71	4.0
1970–71 – 1984–85@	9.1

* Rate of change in the price level is worked out on the basis of index numbers of wholesale prices (average of months).

@ Provisional.

2.19 There has been a continuous emphasis under the successive Plans on achieving the objective of social justice through the implementation of various schemes including the provision of finance on easy terms to designated sections of the population. In recent years there has been greater stress on amelioration of poverty through special schemes included in the Plans, such as the Integrated Rural Development Programme, and the National Rural Employment Programme. The strategy for the Sixth Plan recognised that "Alleviation of rural poverty will be the prime objective of the Sixth Plan",[6] and provided for implementation of three broad categories of programmes. These were a) Resource and income development programme for the rural poor, b) Special area development programme, and c) Works programme for creation of supplementary employment opportunities. The importance of strengthening credit delivery systems of the co-operative banks and commercial banks has been recognised in the successive Plans. Particularly since the major segment of the commercial banking system was brought under the public sector in 1969, policy induced credit flows to the priority sector have significantly contributed to the growth of the small scale industries and promoted the development of entrepreneurship in the small scale sector. We shall be commenting later on the role of banks in furthering the Plan objective of social justice.

2.20 The objective of self-reliance involves reduction in the dependence on foreign aid as a source of funds for the country's develop-

6. Sixth Five Year Plan (Planning Commission, Government of India) p. 169.

Table 7 : Share of the Public Sector in GDP and in Gross Domestic Capital Formation

(at current prices)

Plan Period	% Share of the public sector in	
	Gross Domestic Product at factor cost	Gross Domestic Capital Formation
First Five Year Plan (1951-52 – 1955-56)	8.5	14.3
Second Five Year Plan (1956-57 – 1960-61)	9.3	21.9
Third Five Year Plan (1961-62 – 1965-66)	11.5	32.3
Annual Plans (1966-67 – 1968-69)	13.9	35.3
Fourth Five Year Plan (1969-70 – 1973-74)	16.0	39.4
Fifth Five Year Plan (1974-75 – 1978-79)	18.9	46.3
1979-80	22.6	47.7
Sixth Five Year Plan (1980-81 – 1984-85)		
1980-81	23.2	46.2
1981-82	22.1	48.3
1982-83	24.5	49.2
1983-84 (Quick Estimates)	23.2	46.2
1984-85	–	–

: Not available.

Source : Computed from annual data published in National Accounts Statistics (Central Statistical Organisation, Government of India).

Table 8 : Pattern of Financing of the Public Sector Plan Outlay

(per cent)

Financial Resources For the Public Sector Plan	First Five Year Plan	Second Five Year Plan	Third Five Year Plan	Annual Plans	Fourth Five Year Plan	Fifth Five Year Plan		Sixth Five Year Plan (first four years)
	1951-56	1956-61	1961-66	1966-69	1969-74	1974-79	1979-80	1980-85
Total Public Sector Plan Outlay (Rs. crores)	1,960	4,672	8,377	6,756	16,160	39,303	12,601	80,605
Resources (as per cent of outlay)								
Balance from current revenue at pre-Plan rates of taxation	19.5	0.2	(–) 4.9	4.5	(–) 1.5	12.5	22.4	7.3
Additional Taxation*	13.0	22.5	33.7	13.5	26.5	37.4	12.0	27.2
Surplus of Public Sector Undertakings †	5.9	3.6	5.1	6.0	7.0	2.2	13.5	7.0
Sub-Total : Own Resources	38.4	26.3	33.9	24.0	32.0	52.1	47.9	41.5
Market borrowings and term loans from financial institutions	14.1	11.6	9.6	10.6	21.3 £	16.6	20.6	23.2
Small Savings etc. @	24.6	14.6	15.0	19.3	21.0	13.1	12.2	14.3
External Assistance	9.6	22.4	28.2	35.9	12.9	14.8	8.6	8.4
Deficit financing **	13.3	25.0	13.2	10.1	12.8	3.4	10.8	12.7
Sub-Total : Other Resources	61.6	73.6	66.0	75.9	68.0	47.9	52.2	58.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* Additional taxation including measures to increase the surplus of public sector undertakings.

£ Includes retained profits of the Reserve Bank.

@ Includes small savings, Annuity deposits, compulsory deposits, State Provident Fund, miscellaneous capital receipts and others.

† Excluding yield from measures adopted for raising additional resources for the Plan.

**Deficit financing refers to changes in government (Central and States) indebtedness, both long-term and short-term, to the Reserve Bank of India.

Note : Components may not add up to totals due to rounding.

Source : Computed from data published in Report on Currency and Finance (Reserve Bank of India).

ment programmes. The major policies in the area of foreign trade, accordingly, were focused on promotion of exports, import substitution, and reduction in non-essential imports. Several sectoral programmes aiming at self-reliance in food, oil and fertilisers were taken up in the Plans, and considerable success has been achieved in the reduction in the share of imports in the total availability of food and capital goods. Further, an appreciable rise in exports occurred since the early Seventies as a result of greater diversification in the structure of production. These led to a substantial decline in the dependence on foreign aid.

2.21 In the implementation of the Five Year Plans, the public sector has been assigned a vital role. Accordingly, public sector investment which is predominantly related to the development of infrastructure, also covers investment in several important industries, trade, transport and communications, irrigation and other major investments in agriculture. In particular, the high level of investment in infrastructure and key industries by the public sector has stimulated investment in the private sector through a rise in the public sector demand for private sector goods. Trends in the share of the public sector in GDP and gross domestic capital formation are shown in Table 7. The public sector has reached commanding heights in the economy over the last three decades and presently accounts for nearly one-fourth of GDP and more than two-fifths of the investment in the economy. As an increasingly important role was assigned to the public sector in stepping up economic activity in the country, it became necessary to ensure that the public sector gained commensurate command over the resources of the economy. The ratio of taxes to national income has been raised over the years, and the structural and organisational changes in the financial system have also enabled the public sector to draw upon the country's financial resources in an increasing measure.

2.22 We would like to review briefly the financing of the successive Five Year Plans which has a vital link with the functioning of the monetary system. The important sources of finance for meeting the public sector Plan outlay are (a) taxation and public sector saving,(b) market borrowings and other budgetary resources of the Central and State Governments,(c) external resources and (d) deficit financing. The pattern of financing of the public sector Plan outlay during the successive Plans is shown in Table 8. Internal resources in the form of tax revenues and surplus of public sector enterprises contributed about 40 per cent to 50 per cent of the total public sector outlay in the recent Plans. While the share of domestic market borrowings has increased, the share of external borrowings has shown a decline. Deficit financing provided 10 per cent to

Table 9 : Trends in Government Expenditure

(Rupees Crores)

Year ending March	GNP at market prices (at current prices)	Total Government Expenditure (Centre and States)	Changes in RBI Credit to Government (net)*	Total Government Expenditure as per cent of GNP	Changes in RBI Credit to Government (net) as per cent of total Government Expenditure
1970-71	39979	8847	500	22.1	5.7
1971-72	43065	10511	689	24.4	6.6
1972-73	47563	12319	800	25.9	6.5
1973-74	58615	13482	745	23.0	5.5
1974-75	69304	16255	336	23.5	2.1
1975-76	73829	19912	354	27.0	1.8
1976-77	79764	22298	838	28.0	3.8
1977-78	89350	24422	-118	27.3	—
1978-79	97424	28194	1502	28.9	5.3
1979-80	107315	31670	3259	29.5	10.3
1980-81	127787	39160	4038	30.6	10.3
1981-82	147490	44479	3224	30.2	7.2
1982-83	162895	52057	2647	32.0	5.1
1983-84	195058	60748 @	4311	31.1	7.1

*Data for 1970-71, and 1975-76 to 1982-83, are as on March 31 on the basis of closure of Government accounts and for the remaining years as on the last Friday of March.

@ Revised Estimates.

Sources : Report on Currency and Finance (Reserve Bank of India).
National Accounts Statistics (Central Statistical Organisation, Government of India).

13 per cent of the Plan resources since the Third Plan, except during the Fifth Plan when it accounted for 3.4 per cent. The estimates of the likely order of deficit financing during the Plan periods which are made at the time of formulation of the Plans have been generally exceeded in practice. While some extent of deficit financing is desirable to step up investment expenditures, deficit financing of the order of 10-13 per cent over most Plan periods has resulted in a high rate of monetary expansion and consequently accentuated inflationary pressures.

2.23 The expenditures of the Central and State governments have risen steeply since 1970-71 as a proportion of GNP at market prices. Government's recourse to credit from the Reserve Bank has also increased as can be seen from Table 9. The factors leading to the high share of deficit financing in the domestic resources deployed in financing government expenditures in recent years need to be carefully analysed. At the outset it may be noted that starting from a low saving rate of 10.2 per cent in 1950-51 the country achieved a saving rate as high as 22.6 per cent in 1983-84 which represents a commendable increase, and compares favourably with the saving rate achieved in even the more successful among the developing countries. The broadening and deepening of the financial system over the past decades as a result of a number of policy initiatives has facilitated this rise in the saving rate in the course of planned economic development. Of particular significance is the extent of what we may term 'monetary deepening' that has occurred over the years, more notably since the early Seventies as can be seen from the ratio of real money balances to real net national product at 1970-71 prices which rose from 0.32 in 1970-71 to 0.49 in 1983-84. Financial savings have risen significantly in volume over the last three decades and the monetary system accounts for a substantial portion of these savings. Despite these favourable developments government has been incurring deficits which suggests that its access to savings falls short of its expenditures and is not keeping pace with the growing demands on government which are reflected in the rising volume of subsidies, buffer stocking operations, as also developmental expenditures. The virtual absence of downward flexibility in the price level, and the rising quantum of interest payments on a growing volume of domestic borrowings have also contributed to the sharp increase in current expenditures over the years while current revenues have not shown the same degree of buoyancy. The revenue account of the combined budgets of the Central and State governments reveals sizeable deficits since 1982-83, instead of a surplus which was in evidence in earlier years. The increased recourse to deficit financing is a disconcerting development and it is necessary to ensure that deficit financing, measured in terms of recourse to credit from the Reserve Bank, does not exceed safe limits. This implies that Plan expenditures should be financed in a non-

inflationary manner by tapping the savings of the public in greater measure than in the past, apart from realising higher savings from the public sector enterprises, and improving efficiency in revenue gathering and expenditure functions. Only then the process of planned economic development can maintain its momentum and also ensure that its benefits reach the target groups without being eroded by inflation.

Chapter 3 : PUBLIC DEBT

We have already noted the growing importance of the public debt in the financing of government expenditures. In this chapter we shall review the nature of the public debt and some of its features that are of particular relevance to the monetary system.

3.2 On the basis of methods adopted to raise funds in India, liabilities of the government to the public, other than external debt, could be classified into (a) marketable debt, (b) small savings and (c) other liabilities. Included in the first category are all dated securities, compensation and other bonds of the Central and State governments, and Treasury Bills of the Government of India, apart from Special Bearer Bonds which have been issued infrequently by the Government of India. Other liabilities include Public Provident Fund, State Provident Funds, Other Accounts (relating to insurance and pension funds, trusts and endowments, and Special Deposits and Accounts), Reserve Funds and Deposits, Special Floating and other loans, special securities issued to the Reserve Bank of India, ways and means advances to State Governments from the Reserve Bank of India, and loans and advances from banks and other institutions to State Governments.

3.3 At the time of formulating budgetary proposals the quantum of market borrowings is determined on the basis of factors such as the estimated growth of investment in government securities by banks, provident funds and insurance companies, and the repayment liability during the year in respect of borrowings of the Central and State Governments. The loans are issued in different tranches inviting subscriptions from the market in the form of conversion of maturing stock or in cash.

3.4 The marketable debt of the Government of India which stood at Rs. 6,958 crores at the end of March 1971 increased five-fold to a level of Rs. 43,294 crores by March 1984 as can be seen from Table 1. The rise has been rather sharp since 1977; in the seven year period 1977-78 – 1983-84 the average net amount raised annually was as much as Rs. 4,265 crores as against the average net amount of Rs. 1,080 crores in the six year period 1971-72 – 1976-77.

3.5 As marketable debt issued by the Central Government has increased markedly since 1970-71, the relative share of the State Govern-

Table 1 : Profile of Marketable Debt and Other Liabilities of the Central and State Governments

(Rupees Crores)

End March	Central Government								State Governments				
	Marketable Debt		Small Savings		External Debt*		Other Liabilities	Total Liabilities	Marketable Debt		Other Liabilities	Loans and Advances from the Central Govt.	Total Liabilities
1971	6958	(17.3)	2209	(5.5)	6485	(16.1)	4212	19864	1233	(3.1)	1151	6365	8749
1972	7605	(17.5)	2432	(5.6)	6831	(15.8)	4554	21422	1332	(3.1)	1506	6732	9570
1973	9471	(19.8)	2802	(5.8)	7124	(14.9)	4544	23941	1465	(3.1)	1120	7960	10545
1974	10374	(17.6)	3276	(5.5)	5869	(10.0)	4751	24270	1625	(2.7)	1376	8579	11580
1975	11635	(16.7)	3554	(5.1)	6421	(9.2)	5226	26836	1840	(2.6)	1557	9148	12545
1976	12937	(17.4)	3946	(5.3)	7489	(10.0)	5778	30150	2107	(2.8)	1928	9682	13717
1977	13440	(16.8)	4359	(5.4)	8611	(10.8)	7198	33608	2289	(2.8)	2104	10408	14801
1978	17976	(20.0)	4904	(5.5)	8985	(10.0)	8308	40173	2471	(2.7)	2487	11529	16487
1979	18619	(19.1)	5751	(5.9)	9373	(9.6)	9739	43482	2656	(2.6)	2593	13890	19139
1980	23259	(21.7)	6856	(6.4)	9964	(9.3)	10136	50215	2838	(2.7)	3001	15739	21578
1981	28739	(22.4)	7976	(6.2)	11298	(8.8)	11736	59749	3033	(2.4)	3869	17071	23973
1982	30007	(20.3)	9375	(6.4)	12328	(8.4)	16476	68186	3369	(2.3)	5182	19071	27622
1983	41056	(25.1)	11098	(6.8)	13682	(8.4)	19036	84872	3758	(2.3)	5105	23550	32413
1984 @	43294	(22.1)	13298	(6.8)	15311	(7.8)	23207	95110	4318	(2.2)	6144	26722	37184

@ Revised Estimates.

* Includes loan from IMF Trust Fund.

Figures in brackets are percentages to gross domestic product at current market prices.

Source: Report on Currency and Finance (Reserve Bank of India).

Table 2 : Composition of Marketable Debt of the Central Government

(Rupees Crores)

End March	Treasury Bills	Other Marketable Debt
1971	2516 (36.1)	4442 (63.9)
1972	2765 (36.4)	4840 (63.6)
1973	4044 (42.7)	5427 (57.3)
1974	4384 (42.3)	5990 (57.7)
1975	5064 (43.5)	6571 (56.5)
1976	5810 (44.9)	7127 (55.1)
1977	5368 (39.9)	8072 (60.1)
1978	8619 (47.9)	9357 (52.1)
1979	7608 (40.9)	11011 (59.1)
1980	10196 (43.8)	13063 (56.2)
1981	12851 (44.7)	15888 (55.3)
1982	10273 (34.2)	19734 (65.8)
1983	17431 (42.5)	23625 (57.5)
1984*	15549 (35.9)	27745 (64.1)

* Revised Estimates.

Figures in brackets are percentages to marketable debt of the Central Government.

Source: Report on Currency and Finance (Reserve Bank of India).

ments in marketable debt outstanding which was 15.1 per cent in March 1971 declined to 9.1 per cent in March 1984.

3.6 As a proportion of gross domestic product at current market prices the outstanding amount of Central Government securities including Treasury Bills ranged between 16.7 per cent and 19.8 per cent between 1970-71 and 1976-77. This proportion rose to a level of 25.1 per cent by 1982-83 and declined to 22.1 per cent in the following year. The share of Treasury Bills with a maturity of 91 days in marketable debt of the Central Government fluctuated from year to year and ranged between 34.2 per cent and 47.9 per cent during 1970-71 – 1983-84 (Table 2).

3.7 Reflecting a shift in the preference of the investing public, the maturity pattern of the securities issued over the years has undergone a distinct transformation (Table 3). Securities with a maturity of less than five years formed about one-third of the total securities outstanding at the beginning of the Seventies. Since 1973-74 their share showed a persistent fall and was at a low of 11.9 per cent in 1980-81. There was a slight increase in their share in the following three years. Correspondingly, the proportion of long-term securities, i.e., those with maturity of over 10 years, increased markedly from 43 per cent in 1970-71 to 72 percent in 1983-84. The share of medium-term securities did not reveal any perceptible change barring a temporary spurt in the middle of the Seventies.

3.8 Of the loan amounts raised through market borrowings during a year, long-dated securities with maturities over 10 years accounted for about 87 per cent in 1970-71, 86 per cent in 1975-76 and 82 per cent in 1983-84. The share of medium-dated securities which formed about 13 per cent and 14 per cent of the total during 1970-71 and 1975-76 respectively, went up to 18 per cent in 1983-84 and the balance was in the form of short-dated securities of maturities under five years. The shift in the maturity structure of government securities is ascribable to factors such as the nature of investible funds, the level of coupon rates for different maturities, the pattern of ownership of public debt, and the risk of depreciation.

3.9 The coupon rates and yield rates on government securities have been out of alignment with other rates in the economy over the last decade as can be seen from Table 4. The policy in recent years has, therefore, been to gradually raise the interest rates on government securities. The annual changes in coupon rates which represent the nominal interest rates on government securities were marginal upto 1979-80. However, the mark-up effected in the coupon rates in 1982-83 and 1983-84 has been of the order of one percentage point in the case of long-dated securities. The upward revision in the coupon rate of medium-dated securities was lower than that in respect of the long-dated securities during 1980-81 – 1982-83. There were

Table 3: Maturity Pattern of Government of India Rupee Loans

(Rupees Crores)

End March	Undated		Over 10 years		Between 5 and 10 years		Under 5 years		Total
	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total	
1961	257.85	10.0	690.45	26.9	756.41	29.4	866.62*	33.7	2571.33*
1971	257.83	5.9	1886.01	43.0	635.17	14.5	1605.92	-	4384.94
1972	257.83	5.4	2309.45	48.3	668.49	14.0	1548.76	32.4	4784.53
1973	257.83	4.8	2871.57	53.5	855.76	16.0	1377.79	25.7	5362.94
1974	257.83	4.3	3380.05	57.0	1339.60	22.6	957.05	16.1	5934.54
1975	257.83	4.0	3731.01	57.2	1435.89	22.0	1092.29	16.8	6517.02
1976	257.83	3.6	4083.58	57.5	1601.78	22.6	1160.87	16.3	7104.07
1977	257.83	3.2	4950.20	61.4	1671.96	20.8	1177.16	14.6	8057.14
1978	257.83	2.8	6077.85	65.1	1591.20	17.0	1413.44	15.1	9340.32
1979	257.83	2.4	7465.94	67.9	1693.59	15.4	1576.85	14.3	10994.21
1980	257.83	2.0	9049.47	70.0	1851.83	14.3	1761.92	13.6	12921.05
1981	257.83	1.6	10960.42	70.0	2582.65	16.5	1864.34	11.9	15665.24
1982	257.83	1.4	12810.19	68.9	3052.86	16.4	2458.08	13.2	18578.96
1983	257.83	1.2	15881.28	71.0	3075.54	13.8	3144.37	14.0	22359.02
1984	257.83	1.0	19112.78	72.4	3736.36	14.2	3281.77	12.4	26388.74

Note: Maturity classification is as of March 31 every year.

* Including 5 year interest-free prize bonds issued from April 1960.

Source: Report on Currency and Finance(Reserve Bank of India).

Table 4: Interest Rates on Selected Financial Assets

(per cent per annum)

Year Ending March	Coupon Rates on Central Government Securities			Commercial Bank Deposits	Company Deposits	National Savings Certificates
	Short-Term (Below 5 years)	Medium-Term (Between 5 and 10 years)	Long-Term (Over 10 years)	Above 5 years	3 years	
1974-75	5.25	5.00	6.25	10.00	9.50 – 16.00	8.25
1975-76	—	5.00	6.50	10.00	9.50 – 16.50	10.25
1976-77	—	5.50	6.50	10.00	11.00 – 16.00	10.25
1977-78	—	5.50	6.50	9.00	11.00 – 16.50	10.25
1978-79	—	6.00	6.75	9.00	10.50 – 15.00	10.25
1979-80	—	6.25	7.00	10.00	10.50 – 15.00	10.25
1980-81	—	6.50	7.50	10.00	13.00 – 15.50	10.75
1981-82	6.00	6.75	8.00	10.00	13.00 – 15.50	12.00
1982-83	6.25	7.25	9.00	11.00	10.50 – 15.50	12.00
1983-84	—	7.75	10.00	11.00	14.00 – 15.00	12.00
1984-85	—	8.50	10.50	11.00	14.00 – 15.00	12.00

Source: Report on Currency and Finance (Reserve Bank of India).

no issues of short-dated securities by the Central Government after1982-83 when they were issued at 6.25 per cent. The spread between the rates on medium-dated securities and the long-dated securities which was quite narrow during the mid-Seventies widened to 2.25 percentage points by 1983-84. It should, however, be noted that the maximum interest rate of 10.50 per cent per annum offered during 1984-85 on government securities with a maturity of as long as 30 years still remains below the maximum rate being offered by banks on term deposits of more than five year maturity, or yields available on other comparable financial instruments.

3.10 The major investors in the gilt-edged market are commercial banks, insurance companies, provident funds and other trust funds. The market is, however,narrow. Investment by households in government securities has been negligible. The latest available data indicate that holdings of rupee debt of the Central Government by individuals declined from Rs. 26.3 crores (0.8 per cent of total) in 1969, to Rs. 8.6 crores (0.1 per cent) in 1978, and their holdings of State Government securities declined from Rs. 22.4 crores (2.1 per cent of total) to Rs. 5.3 crores (0.2 per cent). All the aforementioned financial intermediaries mobilise savings from the community and investments made by them in government securities represent a transfer of institutionalised savings to the government sector. Investments by these institutions are governed as to their nature and manner, by the respective statutes applicable to their operations. The Reserve Bank of India holds securities on its own account, as also for the purpose of conducting open market operations. Under the Banking Regulation Act, banks are under obligation to invest a part of their deposit resources in liquid assets in the form of cash, gold and unencumbered government and other approved securities as a secondary reserve and accordingly are required to maintain the prescribed Statutory Liquidity Ratio. The Life Insurance Corporation has to invest not less than 50 per cent of its accruals in the form of premium income (addition to the "Controlled Fund") in government and other approved securities subject to a minimum of 25 per cent in Central Government securities. Similarly, General Insurance Corporation and its subsidiaries have to invest 35 per cent of their fresh accruals of investible funds in government and other approved securities with a minimum of 25 per cent in Central Government securities. Provident funds are required to invest 30 per cent of their accruals in government securities with a break up of 15 per cent in Central Government securities and the balance in State Government and other approved securities.

3.11 Data on the holdings of government securities by different categories of investors presented in Table 5 highlight the shifts in the ownership pattern of government debt in the recent period. The Reserve Bank of India was traditionally the single largest holder followed by commercial

Table 5: Ownership of Central Government Securities — Selected Years

(Rupees Crores)

Category of Holders	End March 1976		End March 1977		End March 1980		End March 1983*	
	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total	Amount	Per cent to total
Total	7092.6	100.0	8045.7	100.0	12909.6	100.0	22359.0	100.0
Of which:								
I. State Governments	201.1	2.9	218.7	2.7	232.5	1.8	220.6	1.0
II. Reserve Bank of India (Own Account)	2256.6	31.8	2149.8	26.7	2628.7	20.3	6333.7	28.4
III. Commercial Banks	2064.5	29.1	2664.2	33.1	5793.5	44.9	8704.1	38.9
IV. Life Insurance Corporation of India	875.1	12.3	994.4	12.4	1519.7	11.8	2464.0	11.0
V. Employees' Provident Fund Scheme	660.1	9.3	687.3	8.5	774.8	6.0	755.8	3.4
VI. Provident Funds of Exempted Establishments	789.7	11.1	866.6	10.8	1199.7	9.3	1591.7	7.1
VII. Others	245.5	3.5	465.0	5.8	760.7	5.9	2289.1	10.2

Provisional.

Source: Report on Currency and Finance (Reserve Bank of India).

banks, provident funds and Life Insurance Corporation of India. Since 1976-77, however, commercial /banks' holdings have exceeded those of other categories of holders following periodical upward revisions in the Statutory Liquidity Ratio. The share of commercial banks varied between 33 per cent and 45 per cent and that of the Reserve Bank from 20 per cent and 28 per cent during the period 1976-77 through 1982-83, according to the latest available data on ownership of government securities.

3.12 The Reserve Bank's share in the total outstanding Central Government securities fell from 36 per cent in March 1971 to 20 per cent in March 1979 but rose to 28 per cent by March 1983 while that of commercial banks increased significantly from 21 per cent in March 1971 to a high of 45 per cent by March 1980 and declined thereafter to 39 per cent in March 1983. The share of all categories of provident funds declined from 23 per cent in March 1971 to 20 per cent in March 1977 and to 12 per cent in March 1983 which in part reflected the liberalisation of rules governing deployment of their resources. The proportion of the State Governments' investments was very small at around 3 per cent till 1976-77 and moved downward thereafter to a low of 1 per cent in 1982-83.

3.13 One aspect of market borrowings of the Central Government that needs to be highlighted is that, over the years, the Reserve Bank has been called upon to take up a sizeable proportion of the new issues. The Reserve Bank's subscription to the total net loans floated was about 64 per cent in 1981-82 as per latest available data (Table 6).

Table 6: Monetisation of Public Debt
(Central Government Securities)

(Rupees Crores)

Year	Net Market Borrowings	Initial Cash Contribution of the Reserve Bank to Net Market Borrowings	
	Amount	Amount	Per cent
1978-79	1653	642	39
1979-80	1961	1042	53
1980-81	2603	1377	53
1981-82	2904	1565	64

Source: Report on Currency and Finance (Reserve Bank of India).

3.14 The budgetary deficit of the Central Government is financed by borrowing through the issue of Treasury Bills and/or drawing down the cash balances with the Reserve Bank. The Treasury Bills are sold on tap, at a discount, by the Reserve Bank as the agent of the government. The effec-

Table 7: Sales of Treasury Bills during the year

(Rupees Crores)

Year Ending March	Total	RBI	Banks	State Governments	Others
1970-71	9286	7975	271	835	206
		(85.9)	(2.9)	(9.0)	(2.2)
1974-75	19976	14901	3210	1621	245
		(74.6)	(16.1)	(8.1)	(1.2)
1975-76	22744	17041	3556	1838	309
		(74.9)	(15.6)	(8.1)	(1.4)
1976-77	22053	15106	4178	2524	245
		(68.5)	(19.1)	(11.4)	(1.1)
1977-78	25013	12573	9813	2305	324
		(50.3)	(39.2)	(9.2)	(1.3)
1978-79	28198	7033	16676	4092	399
		(25.0)	(59.1)	(14.5)	(1.4)
1979-80	35165	14661	14678	5374	452
		(41.7)	(41.7)	(15.3)	(1.3)
1980-81	51619	9572	35900	4815	1333
		(18.5)	(69.5)	(9.3)	(2.6)
1981-82	56926	20663	32815	2840	608
		(36.3)	(57.6)	(5.0)	(1.1)
1982-83	73154	6685	61555	4135	779
		(9.1)	(84.1)	(5.7)	(1.1)
1983-84	100123	1380	94235	3679	828
		(1.4)	(94.1)	(3.7)	(0.8)

Figures in brackets are percentages to total.

Source: Report on Currency and Finance (Reserve Bank of India).

tive return is the discount at which they are sold, and is based on the difference between the price at which they are sold and their redemption value. Parliament's sanction is obtained to meet the discharge obligations in respect of Treasury Bills. If during the year the amount of bills to be redeemed exceeds the budgetary provision, sanction for supplementary appropriation is to be obtained for meeting the additional discharge obligation.

3.15 The Treasury Bills are sold in minimum lots of Rs. 25,000 and in multiples thereof. Since September 1966,Treasury Bills are issued in book entry form known as Subsidiary General Ledger Account to banks and other institutional investors. To individuals, however, they are sold in the form of scrips.

3.16 In July 1965, when the sale of Treasury Bills under the tap system was introduced, the rate of discount was fixed at 3.5 per cent per annum. Subsequently, the rate was revised as follows: March,1968 (3 per cent); January, 1971 (3.50 per cent); May, 1973 (4 per cent); April, 1974 (4.25 per cent) and July, 1974 (4.60 per cent). There has been no change in the discount rate since July,1974. At the current rate of discount of 4.60 per cent per annum a Treasury Bill of Rs. 100 (Face Value) is issued at Rs. 98.85. The bills are currently rediscounted by the Reserve Bank at the rate of 4.631 per cent per annum. The exisiting rediscounting facility is such that an investor in Treasury Bills can earn a positive return on his investment even if the bills are rediscounted one day after their purchase.

3.17 Treasury Bills issued by the Government of India in favour of the Reserve Bank of India for the purpose of replenishing the cash balances maintained by it with the Reserve Bank are referred to as *ad hoc* Treasury Bills or *ad hocs*. Treasury Bills are sold throughout the year, on demand. **Treasury Bills once rediscounted by the Reserve Bank of India are not sold again.**

3.18 The trends in annual sales of Treasury Bills to different categories of holders during the recent period are shown in Table 7. The major purchasers of Treasury Bills are banks and the State Governments. Banks accounted for as much as 59 per cent of total sales in 1978-79, 42 per cent in 1979-80, 70 per cent in 1980-81 and 94 per cent in 1983-84.

3.19 An analysis of the ownership of total Treasury Bills outstanding, however, shows a different picture (Table 8). The Reserve Bank of India itself holds over 90 per cent of outstanding Treasury Bills. This is because purchasers of Treasury Bills do not hold them till maturity in view of their very low yield but rediscount bills with the Reserve Bank of India before maturity thus leading to a concentration of holdings with the Reserve Bank

Table 8: Treasury Bills Outstanding — Ownership Pattern

(Rupees Crores)

End March	Total	RBI	Banks	State Governments	Others
1971	2518	2427	16	29	46
		(96.4)	(0.6)	(1.1)	(1.8)
1975	5063	4814	78	134	36
		(95.1)	(1.5)	(2.7)	(0.7)
1976	5810	5096	435	235	44
		(87.8)	(7.6)	(4.0)	(0.7)
1977	5372	5059	48	232	33
		(94.2)	(0.9)	(4.3)	(0.6)
1978	8619	7216	1071	278	54
		(83.7)	(12.4)	(3.2)	(0.6)
1979	7608	6703	135	725	45
		(88.1)	(1.8)	(9.5)	(0.6)
1980	10196	9203	65	834	94
		(90.3)	(0.6)	(8.2)	(0.9)
1981	12851	11844	521	435	51
		(92.2)	(4.1)	(3.4)	(0.4)
1982	10273	9955	151	109	58
		(96.9)	(1.5)	(1.1)	(0.6)
1983	17431	15905	1155	297	74
		(91.2)	(6.6)	(1.7)	(0.4)
1984	15756	14647	938	17	154
		(92.9)	(5.9)	(0.1)	(1.0)

Figures in brackets are percentages to total.

Note : The amounts outstanding shown against different holders other than RBI are net of Treasury Bills rediscounted with the Reserve Bank.

Source: Report on Currency and Finance (Reserve Bank of India.)

of India. The process of funding of Treasury Bills by the government was introduced in 1958-59, with the funding of Rs. 300 crores of *ad hoc* Treasury Bills. Funding in subsequent years has not been of any significant order except in 1981-82 when *ad hoc* Treasury Bills of the face value of Rs. 3,500 crores were funded into special securities issued in favour of the Reserve Bank. Since then no further funding has been resorted to.

3.20 The main attraction of Treasury Bills is their availability on tap, assured yield and low cost of transaction which makes their yield positive even for a one-day investment. These features are of particular relevance to cash management by banks. An additional attraction of Treasury Bills for banks is that they are an eligible asset in the computation of the Statutory Liquidity Ratio to be maintained by banks under the Banking Regulation Act.

3.21 Aside from Treasury Bills, the only other avenue for investment of short-term funds is the call money market. In the call money market overnight funds are transacted at a fluctuating rate of interest which has been subject to a ceiling since 1973. The ceiling is currently 10 per cent. Even though the prevailing call money rate is higher than the return on Treasury Bills, the banks may still choose to invest in Treasury Bills in order to satisfy the SLR requirement. Among banks, the State Bank of India is one of the major investors in Treasury Bills as also a lender in the call money market.

3.22 In Chapter 12 we discuss the key characteristics of the Treasury Bill Market and assess their implications for the monetary system.

3.23 As a consequence of the sizeable increase in the volume of borrowings, the total interest liability of the Central Government escalated from Rs. 604 crores in 1970-71 to Rs. 4,850 crores in 1983-84 (Revised Estimates). This outgo on account of interest payment is in respect of dated rupee securities, Treasury Bills, external debt, small savings (deposits and certificates), State Provident Funds and others. As a proportion of the total revenue of the Central Government, total interest payments amounted to 18 per cent in 1970-71 and 23 per cent in 1983-84.

3.24 Small savings constitute an important source of capital receipts for the government. Savings are mobilised under the different schemes of small savings launched by the Central Government. The small savings instruments broadly comprise 'deposits' and 'certificates'. The net amount received under small savings accounted for about 7 per cent of the total capital receipts in 1970-71 and its share rose to 18 per cent by 1979-80. Thereafter, although the quantum mobilised continued to show a marked improvement, in relation to total capital receipts the proportion of small

Table 9: Small Savings

(Rupees Crores)

Year Ending March	Total Deposits		Total Certificates**		Total current series £		Total un-current series outstandings @	Total current & un-current series outstandings @
	Receipts during the year	Out-standings	Receipts during the year	Outstand-ings	Receipts during the year	Outstand-ings		
1970-71	695	1184	88	92	785	1280	947	2227
1975-76	1445	3179	99	455	1553	3664	573	4237
1980-81	2758	6632	302	1412	3123	8280	207	8486
1981-82	3195	5470	729	2022	4006	9810	126	9936
1982-83	3278	8296	1088	2945	4478	11693	113	11807
1983-84	3608	9010	1689	4462	5329*	13938*	110	14048*

Note: @ Exclude data on '5 year Fixed Deposit – Banks' from September 1971 and '10 year National Plan Certificates' from April 1971 for which data are not available.

* Provisional.

** National Savings Certificates, Annuity Certificates and Social Security Certificates.

£ Includes 5-Year National Development Bonds, and Public Provident Fund Scheme, 1968 (in respect of State Bank of India transactions only).

Source: Report on Currency and Finance (Reserve Bank of India).

savings declined to 13 per cent by 1983-84. However, in relation to gross domestic product at current market prices, small savings remained constant at about 6 per cent between 1970-71 and 1981-82 except during 1974-75 through 1976-77 when the proportion fell to 5 per cent (Table 1). In 1982-83 the proportion improved to 7 per cent and remained at that level in the following year. The total gross receipts from small savings schemes increased from Rs. 785 crores in 1970-71 to Rs. 5,329 crores in 1983-84. The total outstanding amount increased from Rs. 2,227 crores to Rs. 14,048 crores during the same period (Table 9).

3.25 The rate of interest offered on some of the small savings instruments is higher not only with reference to the coupon rates on government securities but in relation to rates on other comparable instruments like bank deposits. Furthermore, investments in small savings carry many fiscal incentives which along with attractive interest rates have helped in the mobilisation of a significant portion of the community's savings. Experience in the matter of attracting savings to small savings media provides an useful indicator of the relevance of interest rates in the mobilisation of resources.

3.26 Marketable debt of State Governments rose from a level of Rs. 1,233 crores in March 1971 to Rs. 4,318 crores in March 1984. Nevertheless in proportion to gross domestic product the States' marketable debt fell from 3.1 per cent in 1970-71 to 2.2 per cent in 1983-84. The net volume of securities issued by State Governments and their sponsored agencies amounted to Rs. 1,244 crores in 1983-84 accounting for about 20 per cent of net borrowings by the Central and State Governments and their sponsored agencies as compared to Rs. 532 crores or 26 per cent in 1977-78 (Table 10).

3.27 State Governments generally issue securities with a maturity of 10 years to 15 years, and the coupon rates on securities were slightly higher than those on comparable maturities floated by the Central Government until 1981-82; under the present policy regarding the terms of borrowing the same coupon rate is offered on securities of comparable maturity.

3.28 Of the total securities issued by the State Governments a rising proportion is held by commercial banks. The proportion owned by these banks increased from 38.7 per cent in March 1971 to nearly 61.3 per cent in March 1983. Next in importance were Life Insurance Corporation of India, provident funds and the State Governments. The holdings of Life Insurance Corporation showed a declining trend over the years from 21 per cent in March 1971 to 12 per cent in March 1983. The Reserve Bank does not subscribe to the securities floated by the State Governments.

Table 10: Net Market Borrowings by Government and Government Sponsored Agencies

(Rupees Crores)

	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
1. Central Government	1191 (60)	1653 (63)	1961 (64)	2603 (69)	2904 (63)	3800 (66)	3793 (62)
2. Agencies sponsored by the Central Government	280 (14)	417 (16)	527 (17)	581 (15)	844 (18)	908 (16)	1082 (18)
3. State Governments	178 (9)	185 (7)	187 (6)	201 (5)	334 (7)	398 (7)	588 (10)
4. State Electricity Boards	187 (9)	225 (9)	266 (9)	298 (8)	389 (9)	444 (8)	450 (7)
5. Other Agencies sponsored by State Governments	167 (8)	139 (5)	112 (4)	121 (3)	125 (3)	147 (3)	206 (3)
6. Total	2003(100)	2619(100)	3053(100)	3804(100)	4596(100)	5697(100)	6119(100)

Figures in brackets are percentages to total.

Source: Report on Currency and Finance (Reserve Bank of India).

3.29 It is important to note that the Central Government in addition to market loans taps not an insignificant proportion of savings through a range of small savings schemes. Besides, the practice of issuing Treasury Bills on tap provides another important source of funds to the Central Government. As far as the State Governments are concerned, over the years there has been some rise in the share of market borrowings in the total capital receipts but this rise has not kept pace with the rise in their expenditure. The increasing reliance of the State Governments on the Central Government and the Reserve Bank has to be viewed in this perspective. The trends in the financial accommodation availed of by the States from the Central Government and the Reserve Bank are presented in Table 11.

Table 11: Resources Raised by the States through Market Borrowings, and Loans and Advances

(Rupees Crores)

Year Ending March	Market Borrowings (Net)	Loans from Central Government	Ways and Means Advances from RBI	Total
1971-72	103	367	375	845
1972-73	134	1228	−490	872
1973-74	167	619	103	889
1974-75	212	561	22	795
1975-76	275	534	44	853
1976-77	179	726	23	928
1977-78	178	1121	75	1374
1978-79	185	2361	−232	2314
1979-80	187	1849	21	2057
1980-81	201	1332	408	1941
1981-82	334	2000	1307	3641
1982-83	398	4479	−1515@	3362
1983-84	588	3172	979@	4739

@ Provisional

Source : Report on Currency and Finance (Reserve Bank of India).

The quantum of loans from the Centre to the States has been rising in recent years. A part of this increase reflects the amount of advances from the Reserve Bank initially utilised by the States and subsequently taken over by the Centre on behalf of the States. The Central Government provides resources to the States through adjustment against assistance for Plan

schemes, or by way of advance payments in respect of States' share of Central taxes and grants-in-aid and in exceptional cases by granting ways and means advances so that the States stay within the limits prescribed for their ways and means advances from the Reserve Bank.

3.30 Under the provisions of the Reserve Bank of India Act,and the Public Debt Act 1944, the management of the public debt and the floatation of new loans are entrusted to the Reserve Bank of India. The operational aspects such as the rules, procedures and practices followed in raising resources for the government are reviewed in the following paragraphs. Transactions relating to the public debt consist of (a)receipt of applications and subscriptions for new loans and issue of scrips against such receipts,(b) payment of interest on such securities and arranging for payment of interest, (c) renewal including consolidation, sub-division and conversion of securities and (d) repayment of the redemption value of security on maturity.

3.31 As a first step in the market borrowing programme of the government, preliminary estimates of the incremental investible resources of major investors like banks, Life Insurance Corporation of India, General Insurance Corporation and provident funds are made by the Reserve Bank having regard to the behaviour of relevant key economic variables. These estimates are communicated to the Government of India, which in consultation with the Reserve Bank decides the total quantum of market borrowings, and the share of the Central Government, the State Governments, all-India financial institutions like IDBI, NABARD, IFCI, ICICI etc., State-level institutions like Electricity Boards, Housing Boards, State Industrial Development and Investment Corporations, Municipal Corporations, etc. The borrowing requirements of State Financial Corporations and the State Land Development Banks are also decided by the Central Government in consultation with the Reserve Bank.

3.32 The Budget of the Central Government presented before the start of the financial year indicates the size of market borrowings to be raised during the fiscal year. On this basis a tentative schedule for floatation is prepared to facilitate successful completion of the market borrowing programme in different tranches. The schedule is fixed in such a way as to coincide with the redemption dates of maturing loans. Borrowing institutions' requirements of funds and the overall state of liquidity in the system are also kept in view. With the notable rise in the size of loans, the Central Government's borrowing programme is completed in six to seven tranches; States' loans are usually raised in one tranche, on or around the dates of maturity of earlier loans. A similar approach is followed in the case of loans guaranteed by government, but if an institution has to raise a comparatively large amount it is permitted to enter the market on more than one occasion.

3.33 The terms and conditions such as the rate of interest, issue prices, maturity period and underwriting commissions for floatation of market loans of the Central and the State Governments and the government-sponsored institutions are finalised by the Reserve Bank in consultation with the Government of India at the beginning of the financial year. All the loans are currently issued at par. The Reserve Bank manages the issue of loans floated by the Central Government and the State Governments. All related functions such as issue of advertisements, loan notification, receipt of application, receipt of subscription, payment of brokerage are attended to by the Reserve Bank; the other categories of borrowers manage their own loan floatations. The offices of the Reserve Bank,however, receive the subscriptions to the loans floated by the IDBI, IFCI and NABARD, and for the IFCI and NABARD, work relating to the servicing of debt such as payment of interest, instalments, renewal, repayment, etc.,is also attended to by the Reserve Bank.

3.34 The Reserve Bank has no special representative in the market and makes use of the services of stock brokers. It maintains an approved list of brokers and the brokers are selected on the basis of reputation, financial standing, volume of business etc. Brokerage at the rate of 6 paise per Rs. 100 is paid on Central and State Government loans and issues guaranteed by the Central Government; brokerage on issues guaranteed by State is subject to a ceiling of 12 paise per Rs. 100. Brokerage is paid to recognised brokers, and to commercial banks in respect of applications tendered by them on behalf of other investors like provident funds. Commercial banks are, however, not permitted to use the services of brokers for subscription to new issues of government loans and have to tender their applications directly to the Reserve Bank. The loans floated by the Central and the State Governments are not underwritten. In respect of other loans the rate of underwriting commission payable to banks and others has been fixed at 38 paise per Rs. 100.

3.35 For the management of the public debt of the government, the Reserve Bank charges a commission on the amount of the public debt outstanding at the rate of Rs. 2,000 per crore per annum, payable half-yearly at the close of the half year for which the charge is made. Besides, the Reserve Bank charges a fee at the rate of Rs. 1,000 per crore of all new issues subject to a minimum of Rs. 5,000 for each loan in respect of Central Government loans and Rs. 1,000 in respect of State Government loans; the expenses incurred by the Reserve Bank in the form of brokerage and on account of printing of loan notification, telegram, advertisement charges etc.,are also recovered from the government concerned.

3.36 Government securities are held in three principal forms viz. (i)

Stock Certificates (ii) Promissory Notes and (iii) Subsidiary General Ledger Account (SGL A/c). In the case of a 'stock', the subscriber is given a certificate stating that he has been registered in the books of the Public Debt Office as the owner of a certain amount of specified loan. A debt held in the form of a ledger account opened by the Public Debt Office in the name of the holder is known as Subsidiary General Ledger Account; no formal certificate is issued to the account holder but he is informed of the opening of the account. Whereas every person can hold a stock certificate, the facility of opening Subsidiary General Ledger Account is restricted to institutions having a corporate status, to government officers who have, in law, the status of 'corporation-sole' and whose total holding justify the opening of such an account. A stock certificate is not transferable by endorsement and delivery and the change in ownership can be brought about only by means of a transfer deed which does not involve any stamp duty. A stock certificate gives complete security against loss by theft, fire etc..Interest is paid by means of interest warrant prepared by the Public Debt Office, at a Public Debt Office, District Treasury or Sub-Treasury. The certificate need not be presented for drawing interest.

3.37 A promissory note contains a promise by the President of India or the Governor of State, as the case may be, to pay to the person or persons named therein a sum of rupees according to the terms and conditions of the particular loan, and to pay interest to the holder. For drawing interest, the promissory note has to be presented at the paying office where it is enfaced. As the promissory note is a negotiable instrument ownership can be transferred by endorsement in full and delivery. Payment of interest on promissory notes on due dates to the holder thus involves a heavy load of work on the Public Debt Office on interest payment dates. A possible solution to this problem which could be examined by the Reserve Bank is payment of interest on the basis of coupons attached to these notes without insisting on presentation of these notes for drawing interest.

3.38 Prior to 1965, the two methods by which Treasury Bills were usually sold to the public, were the "auction method" and "tap method"; under the former method allotment of bills were made to the highest bidder at weekly auctions and under the latter, Treasury Bills were sold on a daily basis at a pre-determined rate of discount. However, from July 1965, Treasury Bills are being sold only on tap. This shift was effected with a view to provide commercial banks with a money market instrument in which they could hold temporarily surplus funds that normally accrue during the slack season. Treasury Bills are sold at a discount and redeemed at par on the expiry of their currency.

3.39 Matters relating to the sale of Treasury Bills are attended to by the Reserve Bank as the agent of the Central Government. The Reserve Bank also passively absorbs a large volume of these bills through its rediscounting window. The ready rediscount facility afforded by the Reserve Bank has resulted in a substantial holding of Treasury Bills by the Reserve Bank in the virtual absence of a market outside the Reserve Bank. Thus the potential of Treasury Bills as a monetary policy tool as well as an efficient money market instrument has not been fully explored during the last decade.

3.40 The first major initiative needed to develop Treasury Bills as a monetary instrument is to move away from an artificially low discount rate to a flexible rate that would make the discount rate on Treasury Bills a pace setter for other rates in the money market. A flexible Treasury Bill rate would enable the monetary authorities to exercise control over money market operations. A flexible rate would also enable the banks to adjust to changes in their short-term liquidity through the purchase and sale of Treasury Bills.

3.41 Reserve Bank accommodation to the commercial banks could also be provided in the form of rediscounting of Treasury Bills. This would go a long way in fostering the market for Treasury Bills. Control on Reserve Bank accommodation could be exercised by specifying limits on rediscount facilities and varying the rate of rediscount for these bills. To the extent the Treasury Bills attain wider acceptability and are also held by non-bank investors, a secondary market in Treasury Bills would evolve. In such a situation the Reserve Bank's operations in Treasury Bills could well be in the nature of market intervention rather than in terms of a rather passive absorption of the Treasury Bills as is the case under the present system. With these structural changes, Treasury Bills could be used as an effective instrument for controlling short-term liquidity as well as for raising short-term resources for the government while reducing its reliance on the Reserve Bank for credit.

3.42 A careful assessment of the likely level of subscriptions by the public to new issues of Treasury Bills and dated government securities has to be undertaken by the Reserve Bank in the initial stages when discount rates and yields are revised. The discount rates to be offered on Treasury Bills and the yield structure on new issues of dated securities need to be determined from time to time and the public's likely response to the new issues has to be assessed. In this task the Reserve Bank may find it useful to get the views of leading securities brokers. Accordingly, it becomes necessary to take steps to encourage and support a number of securities brokers who will take upon themselves the major responsibility in regard to buying and selling of

government securities and act as a link between the Reserve Bank on the one hand and institutions and the general public on the other. Considerable promotional work will have to be done by the Reserve Bank in the present context of a virtually dormant gilt-edged market and development of intermediaries such as brokers of securities would constitute an initial and essential step in this direction. Laying down criteria for empanelment of brokers, evolving guidelines for extension of bank credit to them, formulating special procedures for their handling of work related to purchase and sale of securities by banks, arranging call money facilities for brokers, establishing scale of fees, conventions, and code of conduct for broking business etc., are other necessary follow up actions which the Reserve Bank must take in order to revive the gilt-edged market.

3.43 Government may experiment in a limited way with an alternative proposal that has been made with respect to the floatation of government securities. It has been suggested that government may issue securities without any coupon rate of interest, but at an appropriate discount depending upon the maturity period and the implicit yield. This will have the advantage of doing away with all the procedural and clerical work involved in calculating payment of interest on securities every six months and deducting at source income-tax thereon. This will also do away with the cumbersome practice of calculating interest and tax for preparing a sale or purchase note while selling or purchasing government securities in the market.

3.44 If and when government securities are issued without any coupon rate of interest but at an appropriate discount, the government will stand to lose the revenue from income-tax on income of the nature of interest on government securities. It should be possible to avoid this loss of revenue by modifying the definition of 'income' in section 2(24) of the Income Tax Act, to include difference in market price of government security at the close of previous year and the cost of acquisition or the market value, as the case may be, as on the date of acquisition or the first day of the previous year. Consequential changes may be made in section 18, pertaining to 'interest on securities', in section 28, pertaining to 'profits and gains of business' and in section 56, pertaining to 'income from other sources'.

3.45 Banks and insurance companies may be statutorily required to value such securities which carry no coupon rate of interest at the prevailing market value.

Chapter 4 : THE FINANCIAL SYSTEM

The financial system, consisting of financial institutions, financial instruments and financial markets provides an effective payments and credit system, and thereby facilitates the channeling of funds from the savers (surplus sectors) to the investing (deficit) sectors in the economy. The task of the financial institutions, or financial intermediaries as they are called, is to mobilise the savings of the community and ensure efficient allocation of these savings to high yielding investment projects so that they are in a position to offer attractive and assured returns to the savers. This process gives rise to money and other financial assets which therefore have a central place in the development process. These assets provide the vital links between saving, investment and income.

4.2 As the financial system has an important role to perform in the growth and development of the economy, it is essential that the system a) functions at a high level of both allocational and operational efficiency, b) is stable, and c) introduces innovations in instruments and financing techniques to meet the ever changing preferences of the community of savers and investors. The financial system satisfying these requirements will be in a position to provide an effective means for implementing monetary and other economic policies to achieve the desired socio-economic objectives.

4.3 An overview of the structure and growth of the Indian financial system since the beginning of the 1950s presented in this chapter highlights the growing role of the monetary system which provides what we might term as the infrastructure of the overall financial system.

4.4 The sectoral composition of the saving of the community presented in Table 1 clearly indicates the pre-eminent position of households, whereas government and the private corporate sectors are found to be marginal savers.

4.5 The share of the household sector in the total gross domestic saving was 73.7 per cent in 1950-51, and it continues to occupy its predominant position with a share of 74.3 per cent in 1983-84. The share of saving of the public sector showed fluctuations over the period and was 18.0 per cent in 1983-84 while the share of the private corporate sector was 7.7 per cent.

4.6 Table 2 shows the sectoral distribution of capital formation. The share of public sector in gross domestic capital formation was 23.0,

Table 1 : Sectoral Composition of Gross Domestic Saving

(at current prices)

(Rupees Crores)

Year	Public Sector			Private Corporate Sector			Household Sector			Gross Domestic Saving	
	Amount	Per cent of Gross Domestic Saving		Amount	Per cent of Gross Domestic Saving		Amount	Per cent of Gross Domestic Saving		Total	
1950-51	168	17.2	(1.8)	89	9.1	(0.9)	718	73.7	(7.5)	975	(10.2)
1955-56*	172	12.0	(1.7)	130	9.1	(1.2)	1128	78.9	(11.0)	1430	(13.9)
1960-61*	425	20.6	(2.8)	276	13.4	(1.8)	1362	66.0	(9.1)	2063	(13.7)
1965-66*	809	21.3	(3.4)	396	10.5	(1.6)	2586	68.2	(10.7)	3791	(15.7)
1968-69*	858	18.3	(2.6)	427	9.1	(1.3)	3412	72.6	(10.2)	4697	(14.1)
1973-74*	1807	15.9	(3.1)	1063	9.3	(1.8)	8522	74.8	(14.4)	11392	(19.3)
1978-79*	4781	19.8	(4.9)	1607	6.7	(1.7)	17694	73.5	(18.1)	24081	(24.7)
1979-80	4967	20.0	(4.6)	2249	9.0	(2.1)	17623	71.0	(16.5)	24839	(23.2)
1980-81	4640	15.9	(3.6)	2544	8.7	(2.0)	22030	75.4	(17.3)	29214	(22.3)
1981-82	7277	22.3	(4.9)	2789	8.5	(1.9)	22599	69.2	(15.3)	32665	(22.1)
1982-83	8231	22.0	(5.0)	3157	8.5	(1.9)	25934	69.5	(15.9)	37322	(22.8)
1983-84	7970	18.0	(4.1)	3385	7.7	(1.7)	32817	74.3	(16.8)	44172	(22.6)

* Final year of Plan period

Note : Figures in brackets are percentages of gross domestic product at market prices.

Sources : Report of the Working Group on Savings (Government of India) February 1982.
National Accounts Statistics (Central Statistical Organisation, Government of India).
Quick Estimates of National Income, Consumption Expenditure, Saving and Capital Formation (Central Statistical Organisation, Government of India) January 1985.

per cent in 1950-51; during the same year private corporate sector accounted for 18.9 per cent and households for 58.1 per cent. The share of the public sector rose to 46.2 per cent in 1983-84 while that of the household sector declined to 39.2 per cent and the private corporate sector accounted for 14.6 per cent of gross domestic capital formation during that year. Capital formation in the household sector represents use of funds for acquiring physical assets and for improving existing physical assets. Given the share of the household sector in total gross domestic saving, the decline in the share of the household sector in capital formation indicates an increase in their holding of financial assets facilitating the transfer of their financial savings in increasing measure to the public sector, in the absence of a rise in the share of the private corporate sector in gross domestic capital formation.

Saving of the Household Sector

4.7 Data on saving of the household sector in the form of physical assets and financial assets are presented in Table 3. It can be seen that there has been a marked shift in the composition of its saving. Households have opted more for investment in financial assets in recent years as against physical assets. The proportion of saving in the form of financial assets to total household saving increased from 36.4 per cent during 1951-56 to 56 per cent during 1961-66, and was 54.1 per cent during 1983-84. The reasons for the share of financial assets in total household saving being not much different in 1983-84 as compared to 1961-66 requires to be examined closely. One would expect that the results achieved through planned development and the considerable strengthening of the institutional structure over the years should have contributed to a steady rise in the share of financial saving by households in their total saving. Evidently this process was arrested around the mid 1960s, and the considerable progress in the banking sector since the early 1970s has not made much of an impact on this process. A possible explanation that could be offered is the traditional preference of the household sector for physical assets in a period of inflation, such a preference being reinforced by the relatively low interest rates in real terms offered for their savings during the last two decades. The rate of increase in prices between 1950-51 and 1964-65 on an annual average basis was no more than 2.8 per cent whereas prices rose at 8.8 per cent between 1964-65 and 1983-84. The financial system should probably be given credit for not allowing the share of financial saving to go much below its level in the mid 1960s inspite of the impact of inflation since then. The household sector held its net financial savings (financial assets minus financial liabilities) with banking institutions to the extent of 24 per cent mostly in the form of additions to the holdings of bank deposits and currency, and provided 19 per cent of its net financial savings to non-bank financial institutions, mainly in the form of

Table 2 : Sectoral Distribution of Gross Domestic Capital Formation (GDCF)
(at current prices)

(Rupees Crores)

Year	GDCF	Public Sector	Private Sector			Shares in GDCF (Per cent) Public Sector	Private Sector		
			Total	Corporate Business	House holds		Total	Corporate Business	Households
1950-51	1130	260	870	214	656	23.0	77.0	18.9	58.1
1955-56*	1416	498	918	219	699	35.2	64.8	15.5	49.3
1960-61*	2582	1141	1441	535	906	44.2	55.8	20.7	35.1
1965-66*	4426	2215	2211	696	1515	50.1	49.9	15.7	34.2
1968-69*	5540	2168	3373	756	2616	39.1	60.9	13.6	47.3
1973-74*	11352	4812	6540	1630	4910	42.4	57.6	14.4	43.2
1978-79*	22933	9741	13192	2245	10947	42.5	57.5	9.8	47.7
1979-80	26228	11929	14299	3295	11004	45.5	54.5	12.6	41.9
1980-81	31443	14047	17396	3938	13458	44.7	55.3	12.5	42.8
1981-82	36099	17439	18660	5159	13501	48.3	51.7	14.3	37.4
1982-83	40622	19893	20529	6045	14484	49.2	50.8	15.0	35.8
1983-84	47377	21900	25477	6916	18561	46.2	53.8	14.6	39.2

* Final year of Plan period.

Source : National Accounts Statistics (Central Statistical Organisation, Government of India).

Table 3 : Saving of the Household Sector

(Rupees Crores)

	1951–52 to 1955–56	1956–57 to 1960–61	1961–62 to 1965–66	1966–67 to 1968–69	1969–70 to 1973–74	1974–75 to 1978–79	1979–80	1980–81	1981–82@	1982–83@	1983–84@
a) Financial Assets (Net)*	816 (36.4)	1884 (48.7)	3282 (56.0)	2400 (32.4)	9114 (42.6)	23800 (47.3)	6696 (48.3)	8779 (50.0)	9827 (55.4)	11365 (57.5)	13692 (54.1)
b) Physical Assets (Net)+	1429 (63.6)	1984 (51.3)	2576 (44.0)	5000 (67.6)	12258 (57.4)	26498 (52.7)	7174 (51.7)	8784 (50.0)	7907 (44.6)	8398 (42.5)	11620 (45.9)
c) Saving of the Household Sector (Net) (a+b)	2245 (100.0)	3868 (100.0)	5858 (100.0)	7400 (100.0)	21372 (100.0)	50298 (100.0)	13870 (100.0)	17563 (100.0)	17734 (100.0)	19763 (100.0)	25312 (100.0)

* Net of financial liabilities.
\+ Net of consumption of fixed capital.
@ Provisional.
Figures in brackets are percentages to total saving of the household sector.
Sources : Report on Currency and Finance (Reserve Bank of India) in respect of data on financial assets.
National Accounts Statistics (Central Statistical Organisation Government of India) in respect of data on physical assets.

Table 4 : Financial Surplus of the Household Sector

(Rupees Crores)

	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1966-67 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81	1981-82*
Financial Balance (Surplus)	894	1884	3282	2400	9206	23831	6695	8779	9483
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Acquisition of claims against other Sectors(net)									
i) Banking	214	675	1646	970	4646	13557	2854	4395	3082
	(24)	(36)	(50)	(40)	(51)	(57)	(43)	(50)	(33)
ii) Other Financial Institutions	168	419	845	908	2687	6238	1846	2095	2393
	(19)	(22)	(26)	(38)	(29)	(26)	(28)	(24)	(25)
iii) Private Corporate Business	275	281	253	89	945	1496	875	955	1499
	(31)	(15)	(8)	(4)	(10)	(6)	(13)	(11)	(16)
iv) Government	237	509	540	433	928	2540	1120	1334	2509
	(26)	(27)	(16)	(18)	(10)	(11)	(16)	(15)	(26)

* Provisional.

Figures in brackets are percentages to total.

Sources : Flow of Funds in the Indian Economy, Reserve Bank of India Bulletin.
Report on Currency and Finance (Reserve Bank of India).

contractual saving in Life Fund and Provident Fund during the period 1951-56 (Table 4). By 1981-82 these proportions had risen to 33 per cent and 25 per cent respectively, reflecting the public's increased preference for bank deposits and contractual saving over other forms of financial saving. The net financial saving lent by the household sector directly to the government and the private corporate sector declined from an average of 57 per cent in 1951-56 to 17 per cent during 1974-79 and thereafter rose to 42 per cent in 1981-82.

4.8 In absolute terms, net financial saving of the household sector has risen substantially since the early Fifties. These savings averaged Rs. 179 crores per year in 1951-56, Rs. 656 crores per year during 1961-66, and Rs. 4,766 crores per year during 1974-79. By 1981-82, financial saving of the household sector amounted to as much as Rs. 9,483 crores of which the public sector obtained as much as Rs. 2,509 crores or 26 per cent through small savings scheme, compulsory deposits, sale of government securities, etc., The private corporate sector obtained Rs. 1,499 crores or 15.8 per cent, of which trade credit provided by the unincorporated business component of households provided as much as Rs. 678 crores, the remaining amount representing borrowings from the households and share subscriptions. Of the financial saving of the households in 1981-82, non-bank financial institutions accounted for Rs. 2,393 crores and the banking sector accounted for Rs. 3,082 crores. It may be noted that the banking sector's share of Rs. 3,082 crores in the total financial saving of the household sector is computed, as in the case of other sectors, on a net basis. Accordingly, the loans and advances made by the banking sector to individuals and unincorporated business included in the definition of the household sector, are deducted from the deposits held by the household sector with banks. As banks are increasingly involved in financing individuals and unincorporated business enterprises, and are now providing upto 40 per cent of bank credit under the priority sector lending programme mostly to households, the deposit mobilisation efforts of banks will not be truly reflected in their share of net financial saving of the household sector, but will be evident from an examination of the disposition of gross financial saving of the household sector.

4.9 Data presented in Table 5 show the changes in the pattern of household sector's saving (gross) in financial assets.

4.10 The increase in holdings of currency and deposits accounted for a share of 29.6 per cent of the gross financial saving of the household sector during 1951-56. This share increased to 52.9 per cent during 1961-66, and with some fluctuations in the following years stood at 52.2 per cent during

Table 5 : Saving (Gross) of Household Sector in the Form of Financial Assets
(at current prices)

(Rupees Crores)

	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1966-67 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81 to 1983-84*
(a) Currency	163	507	913	558	2501	3634	1332	7540
	(14.9)	(21.0)	(21.1)	(15.6)	(19.8)	(11.4)	(13.0)	(12.6)
(b) Bank Deposits †	161	550	1377	1259	5080	15094	4659	23697
	(14.7)	(22.8)	(31.8)	(35.1)	(40.3)	(47.2)	(45.4)	(39.6)
(c) Life Insurance Fund	131	189	445	475	1323	2565	773	4526
	(12.0)	(7.8)	(10.3)	(13.2)	(10.5)	(8.0)	(7.5)	(7.5)
(d) Provident Funds ++	178	389	778	752	2381	5959	1748	10529
	(16.3)	(16.1)	(18.0)	(20.9)	(18.9)	(18.6)	(17.0)	(17.6)
(e) Units of Unit Trust of India	–	–	18	37	90	146	40	387
			(0.4)	(1.0)	(0.7)	(0.5)	(0.4)	(0.6)
(f) Claims on Government	310	433	406	239	262	1178	738	5307
	(28.4)	(17.9)	(9.4)	(6.7)	(2.1)	(3.7)	(7.2)	(8.9)
(g) Compulsory Deposits	–	–	–	–	–	1053	–207	15
						(3.3)	(–2.0)	(neg.)
(h) Deposits with Companies	–	94	240	235	383	795	477	4488
		(3.9)	(5.5)	(6.6)	(3.0)	(2.5)	(4.6)	(7.5)
(i) Investments in Shares Debentures of Corporate/Co-operative sector	150	311	240	69	124	504	253	1508
	(13.7)	(12.9)	(5.5)	(1.9)	(1.0)	(1.6)	(2.5)	(2.5)
(j) Trade Credit	–	–58	–88	–36	460	1034	447	1920
		(–2.4)	(–2.0)	(–1.0)	(3.7)	(3.2)	(4.6)	(3.2)
Total (a to j)	1093	2415	4329	3588	12604	31962	10260	59917
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Includes deposits with co-operative non-credit societies.

++ Includes Contributory Pension Fund from 1979-80 onwards.

* Preliminary.

Figures in brackets are percentages to total saving of the household sector in financial assets.

Source : Report on Currency and Finance (Reserve Bank of India).

1980-84. While the overall share of the two instruments has not shown a marked upward trend over the last two decades, the share of bank deposits has increased at the cost of currency holdings, from 31.8 per cent in 1961-66 to 39.6 per cent during 1980-84. This increase is notable, but not as spectacular as the growth in bank deposits during this period would lead one to expect. The share of Life Fund (life insurance premia) and Provident Fund was more or less stable during the periods 1951-56, 1961-66 and in recent years was around 25-28 per cent. Despite favourable fiscal treatment of investment in units of the Unit Trust of India established as early as in 1964, the share of units in the gross financial saving of households was no more than 0.6 per cent during 1980-84. Evidently these are not preferred by the large number of small savers who do not stand to benefit from fiscal concessions, and by high income savers who resort to investment in units only to the extent they are able to benefit from the tax exemptions offered. Financial assets of households representing claims on government were predominantly in the form of contributions under the small savings scheme and accounted for 28.4 per cent of gross financial saving of the household sector in 1951-56, but declined to 9.4 per cent in 1961-66 and to 8.9 per cent during 1980-84. The most notable shift in the disposition of financial assets of the household sector between 1951-56 and 1980-84 is probably the decline in the share of the private corporate and co-operative securities from 13.7 per cent to 2.5 per cent. Households' preference for liquid and risk-free investments is probably indicated by this decline which should be considered in the light of the increase in bank deposits.

Indicators of Financial Development

4.11 The nature, composition and growth of financial assets or claims indicate the sophistication, development and growth of the financial system and hence the overall financial development of the economy. Several indicators have been devised to measure the financial development of the economy. The important indicators are : (i) Finance Ratio (FR), (ii) Financial Inter-Relations Ratio (FIR), (iii) New Issue Ratio (NIR), and (iv) Intermediation Ratio (IR).

4.12 The Finance Ratio (FR) is measured as the ratio of total financial claims issued during a year in the economy (financial issues) to national income. It is an indicator of the rate of financial development in relation to the rate of economic growth.

4.13 The Financial Inter-Relations Ratio(FIR) is the ratio of the total volume of financial assets in the economy at any point of time to the stock of physical assets at that time. It, therefore, reflects the basic aspects of the country's financial structure and development, namely, the relation between its financial structure and its real asset structure. The ratio is, how-

Table 6 : Indicators of Financial Development

Period	Finance Ratio (FR) (annual average)	Financial Inter-Relations Ratio (FIR)	New Issue Ratio (NIR)	Inter-mediation Ratio (IR)
1951-52 – 1955-56	0.04	0.63	0.46	0.37
1956-57 – 1960-61	0.09	0.85	0.58	0.47
1961-62 – 1965-66	0.12	0.98	0.67	0.46
1966-67 – 1968-69	0.12	0.93	0.63	0.48
1969-70 – 1973-74	0.14	1.09	0.61	0.78
1974-75 – 1978-79	0.21	1.25	0.72	0.73
1979-80	0.28	1.60	0.91	0.75
1980-81 and 1981-82	0.25	1.40	0.83	0.70

Sources : Chart Book on Financial and Economic Indicators Reserve Bank of India 1977
Flow of funds in the Indian Economy Reserve Bank of India Bulletin.
Report on Currency and Finance (Reserve Bank of India).

ever, more readily computed on the basis of the change in the volume of financial assets during any period and capital formation during that period. For this reason this ratio is more amenable to analysis in countries which do not have the requisite data relating to the stock of physical assets. In the following paragraphs we use the FIR, as also other financial ratios in the 'incremental' or 'marginal' version.

4.14 The New Issue Ratio (NIR) is an indicator of the extent to which the non-financial sector financed its investment through funds obtained by it. It is measured as the ratio of primary issues to net physical capital formation in the economy, primary issues being defined as financial claims issued by those in the non-financial or real sector.

4.15 The Intermediation Ratio (IR) shows the importance of financial institutions relative to non-financial units (including households) in raising resources to finance investment. This is measured as the ratio of the volume of financial instruments issued by the financial institutions, called secondary issues, to the volume of primary issues by the non-financial units. The Intermediation Ratio provides the most general indicator of the degree of institutionalisation of financing in the economy.

4.16 The indicators of financial development for selected periods beginning from 1951-56 are presented in Table 6.

4.17 The sum of primary and secondary issues in the economy as a proportion of gross domestic product at current market prices as indicated by the Finance Ratio was as low as 0.04 during 1951-56. It increased to 0.12 during 1961-66 and further to 0.21 during 1974-79. The Finance Ratio during the period 1980-82 was 0.25. The upward trend in the Finance Ratio clearly points to the important and increasing role of the financial structure in the Indian economy since the beginning of the First Five Year Plan.

4.18 Financial claims as a proportion of net capital formation have shown an almost steady rise over the years. The FIR was 0.63 during 1951-56, 0.98 during 1961-66 and 1.25 during 1974-79. The FIR was 1.40 during the period 1980-82. The rising ratio indicates a faster growth in the financial claims issued as compared to the growth in physical investment. The trends in the FIR observed in India are perhaps supportive of the hypothesis that in the course of economic development, the financial structure of an economy grows more rapidly than the national income during the early phases of development. The rise in the FIR was a result of an increase in primary issues as also in secondary issues.

4.19 The New Issue Ratio (NIR) rose over the last three decades. This ratio increased from 0.46 during 1951-56 to 0.67 during 1961-66 and to

0.72 in 1974-79. The NIR was 0.83 during the period 1980-82.

4.20 The Intermediation Ratio (IR) also showed a marked rise over the last three decades. The IR was 0.37 during 1951-56. It rose to 0.46 during 1961-66 and to 0.78 during 1969-74. The ratio fell to 0.73 during the period 1974-79 and further to 0.70 during 1980-82. The decline in the ratio in recent years reflects the notable increase in the primary issues by the government and also larger debenture issues by the private corporate business sector.

4.21 The foregoing review of the trends in the four important ratios of financial development highlights the growing importance of financial institutions in the economy and the growth of the financial flows in relation to economic activity, both in the form of direct finance to the deficit sectors (investing sectors) and indirect finance through financial intermediaries.

4.22 The salient features of financial development and growth in India over the last three decades can be summed up as follows :

- The financial structure has grown more rapidly than national income.
- The ratio of financial claims to net capital formation (FIR) increased over the years in the process of development.
- The increase in the relative size of the financial structure to the real structure as shown by FIR is an indication of the greater degree of separation of the functions of saving and investment among different units.
- There has been a marked rise in the institutionalisation of saving as evidenced by increasing ownership of financial assets in the economy. This has led to greater diversity in the financial instruments in the economy. The institutionalisation of saving has made more progress in respect of short-term financial assets particularly monetary assets, than long-term assets, like securities.
- The share of the banking system and other financial institutions taken together in the total financial claims has increased gradually over the years.
- The role of the foreign sector in financing economic activity in the country is declining when compared to the role of domestic financing.
- The share of government sector in the disposition of domestic saving has substantially increased.

Financial Balances of Institutional Sectors

4.23 The inter-relations and developments in the financial system can be understood with the help of flow of funds accounts. Sector-wise saving, investment, financial sources and financial uses of the real sector of the economy comprising government, private corporate business, households

and rest of the world sectors, are presented for selected years in Table 7 along with the resources gap and the financial balances (surplus or deficit) of the sectors.

4.24 The household sector is traditionally the major surplus sector in the Indian economy; 'rest of the world' has also been generally a surplus sector. However, it is the saving of the household sector that is important in financing the deficits of government and private corporate business sectors. In 1951-56 the surplus of the household sector amounted to 1.8 per cent of the GDP. The surplus of the 'rest of the world' was 0.3 per cent of GDP. The private corporate sector's deficit was 0.8 per cent and the deficit of the government sector was 1.8 per cent. It may be noted that due to inadequate coverage of data in respect of transactions of the financial intermediaries, they show either a surplus or a deficit while ideally their sources and uses should be in balance. This leads to some discrepancies in the total surplus and total deficit of the real sector. In 1981-82 the deficit of the government sector was 6.0 per cent of GDP and that of the private corporate sector was 3.0 per cent. These deficits were financed out of the surplus of the household sector amounting to 6.4 per cent of GDP, and by the 'rest of the world' to the extent of 1.8 per cent, the discrepancy referred to earlier being of the order of 0.8 per cent.

4.25 The aggregate deficit of the government sector has increased from Rs. 883 crores during the quinquennium 1951-56 to Rs. 21,380 crores during the quinquennium 1974-79. While during the period 1951-56 the government sector financed 42 per cent of its deficit by borrowing from the banking sector and 15 per cent from other financial institutions, during 1974-79 the reliance on the banking sector remained unchanged, but the contribution of the other financial institutions rose to 26 per cent. In 1981-82, however, the contribution of the banking sector to the deficit of the government sector rose sharply to 64 per cent and that of other financial institutions was 17 per cent. The government sector's reliance on the banking sector and the other financial institutions for financial resources to meet its deficit rose from a level of 57 per cent during the First Plan period to as much as 81 per cent in 1981-82. It should be noted that this high level of the contribution of the banking sector and other financial institutions to the government deficit in 1981-82 partly reflects the higher amount of credit to government from the Reserve Bank. The household sector met 27 per cent of the deficit of government during 1951-56 and its contribution varied between 11 per cent and 28 per cent during the next twentyfive years. In 1981-82, it met 28 per cent of the deficit of the government sector. Resources provided by 'rest of the world' amounted to 11 per cent of the deficit of the government sector during 1951-56, and its share fluctuated considerably being as high as 50 per cent during 1961-69

Table 7 : Financial Balances of Institutional Sectors

(Rupees Crores)

Sector	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1966-67 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81	1981-82†
I. Government Sector									
1. Saving	587	914	2467	1230	4188	13515	3384	2679	4712
2. Capital Transfers (net)	..	..	..	143	1292	−177	..	..	..
3. Investment	1469	3795	6893	5625	13838	33343	10233	11961	14874
4. Resources Gap (3 – 2 – 1)	882	2881	4426	4252	8358	20005	6849	9282	10005
5. Financial Sources	966	3357	5446	5052	11056	28775	11022	13960	11565
6. Financial Uses	83	441	1040	953	3170	7395	1945	3591	2651
7. Financial Balance (Deficit) (5 – 6)	883	2916	4406	4099	7886	21380	9077	10369	8914
	(1.8)	(4.4)	(4.4)	(4.4)	(3.5)	(5.2)	(8.5)	(8.1)	(6.0)
II. Private Corporate Sector									
1. Saving	201	273	540	265	1333	2206	1037	1131	1178
2. Capital Transfers (net)	..	..	..	..	285	..	..	..	..
3. Investment	617	1097	2136	1524	3966	6970	2196	2650	3361
4. Resources Gap (3 – 2 – 1)	416	824	1596	1259	2348	4764	1159	1519	2183
5. Financial Sources	493	934	1734	1244	3216	7236	2912	3688	5625
6. Financial Uses	77	110	138	110	1085	2033	785	1215	1189
7. Financial Balance (Deficit) (5 – 6)	416	824	1596	1134	2131	5203	2127	2473	4436
	(0.8)	(0.1)	(1.6)	(1.2)	(0.9)	(1.3)	(2.0)	(1.9)	(3.0)

(Contd.)

Table 7 : Financial Balances of Institutional Sectors (Concld.)

(Rupees Crores)

Sector	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1966-67 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81	1981-82†
III. Household Sector									
1. Saving	2368	3859	6093	7632	20846	51142	13793	17356	17005
2. Capital Transfers (net)	..	..	..	10	49	53	..	..	..
3. Investment	1429	1984	2576	5232	11640	27025	7174	8784	7907
4. Surplus Resources (1 + 2 – 3)	939	1875	3517	2410	9255	24170	6613	8572	9098
5. Financial Sources	333	531	1046	1188	3501	7826	3564	2443	3587
6. Financial Uses	1227	2415	4328	3588	12707	31657	10260	11222	13070
7. Financial Balance (Surplus) (6 – 5)	894	1884	3282	2400	9206	23831	6696	8779	9483
	(1.8)	(2.8)	(3.3)	(2.6)	(4.1)	(5.8)	(6.2)	(6.9)	(6.4)
IV. Rest of the World Sector									
1. Saving	..	..	..	2420	2046	..	..	..	..
2. Capital Transfers (net)	..	..	..	–153	–1748	..	..	..	..
3. Investment	–	–	–	–	–	–	–	–	–
4. Surplus Resources (1 + 2 – 3)	..	..	..	2267	298	..	..	..	..
5. Financial Sources	–178	–542	+74	+13	+299	+5624	+460	+44	–1448
6. Financial Uses	–38	+1176	+2105	+2279	+596	+2830	+683	+1858	+1178
7. Financial Balance (Surplus/Deficit) (6 – 5)	+140	+1718	+2031	+2266	+297	–2794	+223	+1814	+2626
	(+0.3)	(+2.6)	(+2.0)	(+2.4)	(+0.1)	(–0.7)	(+0.2)	(+1.4)	(+1.8)

† Provisional.
– Not applicable.
.. Not available.
Figures in brackets are percentages to gross domestic product (GDP) at market prices.
Sources : Flow of Funds in the Indian Economy, Reserve Bank of India Bulletin .
Report on Currency and Finance (Reserve Bank of India).

Table 8 : Sector Financing – Government Sector

(Rupees Crores)

	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1966-67 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81	1981-82 *
Financial Balance (Deficit)	883	2 916	4 406	4 099	7 886	21 380	9 077	10 369	8 914
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Financing of Deficit (by Sector)									
Banking	371	1502	1489	1031	4690	9232	4790	6107	5700
	(42)	(52)	(34)	(25)	(60)	(43)	(53)	(59)	(64)
Other Financial Institutions	136	390	514	360	2002	5555	1661	1735	1515
	(15)	(13)	(12)	(9)	(25)	(26)	(18)	(17)	(17)
Private Corporate Business	–38	–89	–114	–41	–259	–794	–264	–193	–241
	(–4)	(–3)	(–3)	(–1)	(–4)	(–4)	(–3)	(–2)	(–3)
Rest of the World	98	842	2211	2038	238	4298	353	1292	1179
	(11)	(29)	(50)	(50)	(3)	(20)	(4)	(12)	(13)
Households.	237	509	540	433	929	2540	1120	1334	2509
	(27)	(17)	(12)	(11)	(12)	(12)	(12)	(13)	(28)
Unidentified	79	–235	–234	278	286	549	1417	94	–1748
	(9)	(–8)	(–5)	(6)	(4)	(3)	(16)	(1)	(–19)

* Provisional.
Figures in brackets are **percentages to total.**
Sources : Flow of Funds in the Indian Economy.Reserve Bank of India Bulletin
Report on Currency and Finance (Reserve Bank of India).

and as low as 3 per cent during 1969-74. In 1981-82 'rest of the world' met 13 per cent of the deficit of the government sector. Table 8 gives the details of financing of the government sector.

4.26 The deficit of the private corporate business sector was met to the extent of 66 per cent by households during 1951-56, the reliance of the sector on the banking sector being only to the extent of 15 per cent. Other financial institutions met 10 per cent of the deficit while government sector met 7 per cent and the 'rest of the world' 2 per cent of its deficit. In comparison, in 1974-79 the banking sector met as much as 41 per cent of the deficit of the private corporate business sector, the share of households declining to 29 per cent, and that of the government sector rising to 9 per cent. The other financial institutions contributed 18 per cent to the deficit while 'rest of the world' became a net borrower. In 1981-82, the deficit of the private corporate business sector was of the order of Rs. 4,435crores. This was financed by the banking sector to the extent of 36 per cent and by other financial institutions to the extent of 18 per cent. Households met 34 per cent of this deficit, and government 4 per cent, the 'rest of the world' contributing 0.3 per cent of the deficit. Details of the financing of the deficit of the private corporate business sector are presented in Table 9.

4.27 The total assets acquired by the banking sector and the other financial institutions in the course of their lending to the deficit sectors increased phenomenally in absolute terms between 1950-51 and 1980-81. Data on the total assets of financial institutions are given in Table 10. These assets were of the order of Rs. 3,481 crores or 36.4 per cent of GDP at current market prices at the end of March 1951, while thirty years later they amounted to Rs. 1,28,915 crores or 101.1 per cent of GDP at current market prices. The relative shares of the banking sector excluding the Reserve Bank, and the other financial institutions have undergone significant changes during this period. While the share of the banking sector (other than RBI) in the total assets of financial institutions was 35.9 per cent in 1950-51 and rose to 48.1 per cent in 1980-81, the share of other financial institutions which stood at 18.0 per cent in 1950-51 increased much more rapidly to 32.2 per cent in 1980-81. The share of the Reserve Bank fell from as high as 46.0 per cent in 1950-51 to 19.7 per cent in 1980-81. It should, however, be noted that the phenomenal growth in the banking habit has led to a steep fall in the currency-deposit ratio and a rise in the money multiplier as a result of which a given amount of financing of the government sector deficit by the Reserve Bank in recent years would imply a much higher monetary expansion as compared to 1950-51.

4.28 In real terms, using the wholesale price index as a deflator, the assets of financial institutions at 1970-71 prices grew at an annual

Table 9 : Sector Financing – Private Corporate Business Sector

(Rupees Crores)

	1951-52 to 1955-56	1956-57 to 1960-61	1961-62 to 1965-66	1967-68 to 1968-69	1969-70 to 1973-74	1974-75 to 1978-79	1979-80	1980-81	1981-82*
Financial Balance (Deficit)	416	824	1596	1134	2131	5203	2127	2473	4435
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Financing of Deficit (by Sector)									
Banking	63	363	812	695	581	2132	571	116	1577
	(15)	(44)	(51)	(61)	(28)	(41)	(27)	(5)	(36)
Other Financial Institutions	40	82	354	226	431	947	371	937	798
	(10)	(10)	(22)	(20)	(20)	(18)	(17)	(38)	(18)
Government	29	95	115	68	200	454	133	123	176
	(7)	(12)	(7)	(6)	(9)	(9)	(6)	(5)	(4)
Rest of the World	8	61	62	60	–67	–112	18	18	12
	(2)	(7)	(4)	(5)	(–3)	(–2)	(1)	(–)	(–)
Households	275	281	253	89	945	1497	875	955	1499
	(66)	(34)	(16)	(8)	(44)	(29)	(41)	(39)	(34)
Unidentified	1	–58	–	–4	41	285	159	324	373
	(–)	(–7)	(–)	(–)	(2)	(5)	(8)	(13)	(8)

* Provisional.

Figures in brackets are percentages to total.

Sources : Flow of Funds in the Indian Economy, Reserve Bank of India Bulletin .
Report on Currency and Finance (Reserve Bank of India).

(Rupees Crores)

	1950–51	1960–61	1970–71	1980–81
I. Banking Sector.	2853	5811	17194	87459
	(82.0)	(68.2)	(66.0)	(67.8)
1) Reserve Bank of India	1601	2478	5463	25383
	(46.0)	(29.1)	(21.0)	(19.7)
2) Commercial Banks	1080	2257	6862	47066
	(31.0)	(26.5)	(26.3)	(36.5)
3) Co-operative Banks	172	1076	4869	15010
	(4.9)	(12.6)	(18.7)	(11.6)
II. Other Financial Institutions	628	2706	8844	41456
	(18.0)	(31.8)	(34.0)	(32.2)
III. Total Assets of Financial Institutions (I + II)	3481	8517	26038	128915

Figures in brackets are percentages to total assets of financial institutions.

Notes : Data are as on last Friday of March in respect of Reserve Bank of India and commercial banks; 30th June for co-operative banks and annual closing dates of the respective financial institutions.

Co-operative banks include State and central co-operative banks, primary agricultural credit societies, primary non-agricultural credit societies, grain banks and central and primary land development banks.

Other Financial Institutions include Small Savings, Provident Funds, insurance companies, Unit Trust of India, financial companies, industrial development banks (viz., Industrial Development Bank of India, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Industrial Reconstruction Bank of India, State Financial Corporations, State Industrial Development Corporations), Export Credit Guarantee Corporation and Deposit Insurance and Credit Guarantee Corporation, and National Bank for Agriculture and Rural Development (NABARD).

Sources : Computed from data given in the following publications :

1) Report on Currency and Finance (Reserve Bank of India).
2) Supplement to Banking & Monetary Statistics of India, Part I (Reserve Bank of India), 1964.
3) Statistical Tables Relating to Banks in India (Reserve Bank of India).
4) Trend and Progress of Banking in India (Reserve Bank of India).
5) Statistical Statements Relating to Co-operative Movement in India (Reserve Bank of India).
6) Annual Reports of various financial institutions.
7) Reserve Bank of India Bulletin (Reserve Bank of India).

compound rate of 8.2 per cent during 1951-61, at 5.6 per cent during 1961-71 and at 6.3 per cent during 1971-81. The much faster growth of financial assets compared to the growth of national income over these years points to a gradual financial deepening of the economy. The various aspects of growth and development of the banking system which has made a significant contribution to this financial deepening are discussed in some detail in the next chapter.

Chapter 5 : GROWTH AND DEVELOPMENT OF THE BANKING SYSTEM

The banking system in India consists of commercial banks and co-operative banks. The former include foreign banks operating in India in addition to Indian banks in the public sector and the private sector. Commercial banks constitute by far the largest segment of the banking system and among these the largest banks accounting for a pre-dominant share of bank deposits are owned by the government. The co-operative banking structure is federal in character; the co-operative banks essentially follow the 'unit' banking principle and provide short-term credit to the rural sector. While land development banks fund the activities related to capital formation in agriculture, urban co-operative banks finance small business in urban areas. Regional Rural Banks are subsidiaries of commercial banks which are specially set up in rural areas to provide credit and other facilities to weaker sections for productive activities in agriculture, trade, industry etc.. The government-owned Post Office Savings Bank is a distinct entity inasmuch as it is oriented towards mobilisation of small savings of the community and does not undertake any lending activity. Table 1 gives a synoptic view of the banking business in India.

5.2 An important aspect of banking in India is the predominance of the public sector. The State Bank of India, its seven associate banks and the twenty nationalised banks which together are referred to in this chapter as the public sector banks now hold a share of more than 90 per cent of total banking business in terms of deposits as well as bank advances. The extent of government control over the organised credit system was enlarged with the nationalisation in July 1969, of fourteen major commercial banks in the private sector each having a deposit liability of Rs.50 crores and above, and again in April 1980 when six more banks with deposit liabilities of not less than Rs. 200 crores each were nationalised. This step brought a substantial segment of banking business under government ownership and reinforced the control over the total financial system which government had already acquired through the ownership of insurance and term lending institutions.

5.3 Since 1969 commercial banks and in particular the 28 public sector banks have made rapid strides in the various spheres of banking operations be it mobilisation of deposits, deployment of credit or geogra-

phical coverage of banking services and have accounted for most of the growth in the banking system (Table 1). Illustratively, deposits with scheduled commercial banks as a percentage of national income rose from 15 per cent in 1969 to 38 per cent in 1984. The share of priority sector advances in total gross bank credit moved up from 14 per cent to 36.7 per cent, with a concomitant fall in the relatively large proportion of credit earlier enjoyed by the medium and large industry and trade. The average size of population per bank branch improved from 65,000 to 15,000 (Table 1). Further, the number of rural branches in the total number of bank branches stood higher at 56 per cent as compared with 22 per cent in 1969 as new rural branches account for a share as high as 63.5 per cent in the total number of new offices opened since nationalisation.

5.4 Traditionally, co-operative credit has been assigned a significant place in the policies governing the provision of rural finance, and the co-operative organisations continue to play a vital role in the Indian monetary system. The total number of all types of co-operative banks and credit societies as at the end of June 1980 (according to the latest data available) stood at over 1,22,000 with an aggregate membership of 790 lakhs and aggregate working capital of about Rs. 15,300 crores. Total deposits mobilised by the co-operative credit system as at the end of June 1980 amounted to Rs. 5,000 crores. The financial assistance to the ultimate beneficiaries in the rural areas provided by the agricultural credit societies and land development banks totalled Rs. 3,850 crores as at the end of June 1980. The amount of loan overdue for repayment by the borrowers of these co-operatives was as much as Rs. 1,307 crores.

5.5 In the sphere of rural credit, the Reserve Bank of India reoriented its policies and activities from time to time recognising the need for a more constructive role in the matter of development, operations and control of agricultural credit. The financial assistance provided by RBI to the co-operative sector for various purposes showed a notable increase over the years. In the matter of monetary policy, co-operatives do enjoy a special or preferential treatment. For example, the Cash Reserve Ratio required to be maintained by co-operative banks remains at the statutory minimum of 3 per cent. Even in regard to the manner of maintenance of CRR, the law is liberal inasmuch as they are allowed to keep cash reserve with themselves or in current account with the RBI, SBI or any other notified bank. Similarly, co-operative banks need to keep an amount equivalent to 25 per cent of their total time and demand liabilities as Statutory Liquidity Ratio although the SLR applicable to commercial banks has been successively stepped up over the years. The structure of interest rates in the co-operative credit sector is also different from that prevailing in other segments of the organised sector.

	June 1969	June 1984
1. Total offices in India	8262	45332
Rural	1833	25372
Semi-Urban	3342	9262
Urban	1584	5769
Metropolitan	1503	4929
2. Population per office (in thousands)	65	15
3. Deposits in India (Rs. Crores)	4646	63852
4. Deposits as percentage of national income (at current prices)	15.2†	37.9†
5. Per-capita Deposits (Rs.)	88	940
6. Deposits per office (Rs. lakhs)	57	141
7. Total Bank Credit in India (Rs. Crores)	3599	43058
8. Credit per office (Rs. lakhs)	44	95
9. Bank Credit to priority sectors (Rs. Crores)	504	14834†
10. Share of priority sector advances in gross bank credit (per cent)	14.0	36.7†
11. Credit-Deposit Ratio— %	77.5	67.4
12. Investment-Deposit Ratio — %	29.3	36.3
13. Cash-Deposit Ratio — %	8.2	14.5

† These figures pertain to March.

Sources : Banking Statistics : Basic Statistical Returns, and Report on Trend and Progress of Banking in India (Reserve Bank of India)

5.6 Thus the operation of co-operative banks has an important bearing on the working of the monetary system considering the special status enjoyed by them in many respects. In the field of rural credit, the operations of co-operatives continue to be sizeable and they are an important constituent of the multi-agency system which has been evolved to meet the growing credit requirements of the rural sector.

5.7 Deposits with scheduled commerical banks aggregating Rs. 63,852 crores at end June 1984 represented a spectacular increase over the level of Rs. 4,646 crores at the end of June 1969. Similarly, there has been a manifold increase in the number of accounts: the number of accounts stood at 145 million at the end of June 1981 as against over 38 million in June 1973. The growth in deposits at an accelerated pace albeit at current prices in more recent years is attributable to higher real growth achieved by the economy, expansion of bank branches and the households' strong preference for bank deposits as a saving medium. Deposits mobilised by rural bank branches constituted about 13 per cent of the total deposits in 1981 as against 3 per cent in 1969 (Table 2). The share of metropolitan branches which mobilised 50 per cent of deposits in 1969, came down to 39 per cent while that of branches in semi-urban and urban centres did not show any perceptible change over the years. The growth in deposits was accompanied by a significant shift in the structure of deposit accounts over the years. The relative importance of term deposits has gone up over the years and they now form about 55.3 per cent of aggregate deposits. This preponderance was evident in all centres classified according to population groups. The proportion of savings deposits at 29 per cent indicated a relatively modest rise over the level prevailing in the late Sixties. More than 86 per cent of current accounts were held by depositors in urban and metropolitan areas. With respect to term deposits, there has been a transformation in the maturity pattern of deposits. Deposits with a maturity of over 5 years constituted about 61.8 per cent of the total term deposits; the proportion was only 6.2 per cent in 1969 (Table 3). Households' preference for deposits of longer maturity which carry the highest interest rate offered on bank deposits is a factor which affects the cost structure of banks. Of total bank deposits 67 per cent is accounted for by the households, 24 per cent belonged to the corporate sector and other institutions, and 9 per cent was held by the government sector. Current account deposits were largely held by corporations and other institutions, while savings and fixed deposit accounts were owned by the households to the extent of 91 per cent and 70 per cent respectively as at end-March 1980.

Table 2 : Distribution of Deposits of Scheduled Commercial Banks

(Rupees Crores)

Population Group*	June 1973				June 1981			
	Current Deposits	Savings Deposits	Term Deposits	Total Deposits	Current Deposits	Savings Deposits	Term Deposits	Total Deposits
Rural	77	263	314	654	395	2277	2588	5261
	(3.8)	(11.0)	(6.6)	(7.2)	(6.3)	(19.3)	(11.6)	(13.0)
Semi-Urban	354	657	1119	2130	1049	3208	5111	9368
	(17.7)	(27.5)	(23.6)	(23.3)	(16.7)	(27.2)	(22.9)	(23.2)
Urban	476	607	1239	2322	1560	2800	5587	9947
	(23.8)	(25.4)	(26.1)	(25.4)	(24.9)	(23.7)	(25.0)	(24.6)
Metropolitan	1094	863	2067	4024	3262	3529	9046	15837
	(54.7)	(36.1)	(43.6)	(44.1)	(52.1)	(29.8)	(40.5)	(39.2)
Total	2001	2390	4739	9130	6266	11814	22332	40413
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

* Based on 1971 Census.

Note : Figures in brackets are percentages to total.

Source : Banking Statistics : Basic Statistical Returns (Reserve Bank of India).

Table-3 Maturity Classification of Term Deposits with Scheduled Commercial Banks

(Rupees Crores)

	Period of Maturity	End March 1969		End March 1980	
		No. of Accounts ('000s)	Amount	No. of Accounts ('000s)	Amount
1.	6 Months or less	308	456.0 (20.2)	235	810.3 (4.7)
2.	More than 6 months and not exceeding 1 year	1499	882.1 (39.1)	682	478.4 (2.8)
3.	More than 1 year and not exceeding 2 years	440	197.6 (8.8)		
4.	More than 2 years and not exceeding 3 years	341	118.5 (5.3)	6684†	3074.3† (17.9)
5.	More than 3 years and not exceeding 5 years	885	461.2 (20.4)	6206	2194.4 (12.8)
6.	Above 5 years	394	139.9 (6.2)	19006	10615.9 (61.8)
	Total	3867	2255.3 (100.0)	32813	17173.3 (100.0)

† Break-up not available.

Note : Figures in brackets are percentages to total.

Source : Statistical Tables Relating to Banks in India (Reserve Bank of India).

5.8 Banks' investment in government securities and other approved securities are made mainly in terms of statutory provisions governing banking operations. The Banking Regulation Act 1949, stipulates that the banks should maintain at the close of business on any day a minimum proportion of their demand and time liabilities in India as liquid assets in the form of cash, gold and unencumbered approved securities. The ratio between liquid assets and the applicable demand and time liabilities is known as Statutory Liquidity Ratio (SLR) and the minimum level of the ratio prescribed under the Act is 25 per cent and the Reserve Bank is empowered to raise the ratio to a level of 40 per cent. The present level of Statutory Liquidity Ratio is 36 per cent and is to be raised in two steps to 37 per cent by July 1985. Investments in government securities constitute

Table 4 : Credit-Deposit Ratio of Scheduled Commercial Banks

(per cent)

Region	June 1973				June 1983			
	Rural	Semi-Urban	Urban/ Metro-politan	Total	Rural	Semi-Urban	Urban/ Metro-politan	Total
Northern Region	21.0	36.5	78.1	64.4	50.8	51.8	73.4	65.9
North-Eastern Region	17.5	29.6	63.0	35.8	50.7	35.3	49.3	42.0
Eastern Region	45.2	22.0	75.7	61.5	54.0	34.5	64.2	56.2
Central Region	42.5	38.8	46.7	44.0	59.6	54.3	46.4	51.2
Western Region	35.3	41.6	83.7	74.1	50.6	49.1	89.4	78.6
Southern Region	88.6	71.4	107.2	94.9	81.0	60.3	91.9	80.0
Total	47.2	42.9	80.8	69.6	59.9	50.8	76.5	68.1

Sources : Banking Statistics : Basic Statistical Returns, and Report on Trend and Progress of Banking in India (Reserve Bank of India).

about 22 per cent of demand and time liabilities or about 60 per cent of total SLR investments.

5.9 Total credit extended by commercial banks showed an increase of 12 times between June 1969 and June 1984. The credit-deposit ratio however fell by almost 10.1 percentage points to 67.4 per cent by 1984 from 77.5 per cent in 1969. This fall reflects mainly the deployment of resources in increasing measure to meet the Statutory Liquidity Ratio and Cash Reserve Ratio requirements. Over the years, however, there has been a reduction in the urban-rural disparities in the credit-deposit ratio; between 1973 and 1983, the credit–deposit ratio of rural branches improved from 47.2 per cent to 59.9 per cent whereas that of urban/ metropolitan centres declined from 80.8 per cent to 76.5 per cent (Table 4). However, banks have yet to achieve the national target laid down by Government of India of 60 per cent in respect of their rural and semi-urban branches separately which was to be achieved by March 1979.

5.10 The lower credit-deposit ratio observed in some regions is not unrelated to the absorptive capacity for productive use of credit. It should, however, be noted that the credit-deposit ratio often does not serve as a reliable indicator of the trends in mobilisation of deposits and deployment of credit in a particular region/area. This is because (a) the ratio does not take into account banks' investment in the securities of State Governments, State level institutions etc., (b) credit might have been sanctioned by offices of banks in metropolitan area but used in rural/urban area or credit sanctioned in one State, might have been deployed in another State and (c) sometimes the amounts of both deposit accretion and credit expansion could be very small but the ratio could be high.

5.11 A significant feature in regard to the allocation of credit since 1969 is the improved sectoral spread of bank finance. At the time of nationalisation of banks, medium and large industry and trade claimed 68 per cent of bank credit. By March 1984 the proportion of amount lent to them came down considerably while the amount advanced to agriculture, small-scale industry, road and water transport operators, retail trade and small business, professional and self-employed persons, education, housing for weaker sections etc., which are designated as priority sectors formed 36.7 per cent of total bank credit as compared to the national target of 40 per cent which the banks were exhorted to reach by March 1985 (Table 5). As a part of priority sector lending, banks have been asked to undertake a special scheme for financing the weakest sections of society. This scheme known as the Differential Rate of Interest Scheme, operative

since 1972 provides for the grant of small loans at a highly concessional rate of 4 per cent per annum. The minimum quantum of lending under this scheme has also been laid down, each bank being required to provide one per cent of its total advances as DRI advances. The major problem faced by banks in administering this scheme as agents of government relates to proper identification of beneficiaries from among a vast number of eligible borrowers so that the weakest among the eligible borrowers benefit from the scheme.

5.12 As a sequel to the rise in credit extended to what has come to be known as priority sector from a level of Rs. 1,208 crores in June 1972 to Rs. 14,834 crores in March 1984, there has taken place a reduction in the relative share of credit made available to the medium and large industries. Nevertheless in absolute terms bank finance extended to these industries rose from Rs. 3,730 crores to over Rs. 14,964 crores between 1972 and 1984.

5.13 Other major claimants of bank credit aside from the priority sector and the industrial sector include agencies set up for procurement, storage and distribution of commodities such as foodgrains, cotton, jute, sugar,and fertilisers, and traders.

5.14 In addition to making finance available to the sectors which fall within the ambit of traditional lending practices, commercial banks have involved themselves in a number of other diverse productive and rehabilitation efforts. These schemes include nursing of industrial undertakings, provision of finance for construction of residential houses, assistance to people affected by natural and other calamities, grant of finance for national bio-gas programme, loans to the beneficiaries of the scheme for providing employment to the educated unemployed youth, special credit facilities to scheduled castes and scheduled tribes, credit facilities to book publishers and book-sellers, loans to the allottees of dealership/distributorship of oil companies under "social objective scheme", loans to the beneficiaries including physically handicapped persons, under Differential Rate of Interest Scheme, Integrated Rural Development Programme, and the New 20 point programme, and loans for education purposes.

5.15 Another aspect worth highlighting is the increasing involvement of banks in term lending. As an established practice banks are known to provide only working capital requirements of their borrowers in view of

Table 5 : Sectoral Deployment of Gross Bank Credit Outstanding*

(Rupees Crores)

	1972 (June)	1984 (March)
Gross Bank Credit	5480 (100)	40454 (100)
1) Public food procurement credit	542 (9.9)	4030 (10.0)
2) Non-food Gross Bank Credit (a+b+c+d)	4938	36424
of which Export Credit	436	2042
a) Priority Sector	1208 (22.0)	14834 (36.7)
Agriculture	439	6133
Small-scale industries	597	5412
Other Priority Sectors	172	3289
b) Industry (Medium & Large)	3730† (68.1)	14964 (37.0)
c) Wholesale Trade (Other than food procurement)		2338 (5.8)
d) Other Sectors		4288 (10.6)

† Includes items (c) and (d).

* Data pertain to 50 banks which account for about 95 per cent of gross bank credit.

Note : Figures in brackets are percentages to total.

Source : Report on Trend and Progress of Banking in India (Reserve Bank of India).

the short-term character of the claims issued by them to the savers. The banks had been meeting the demand for term credit in an indirect way by subscribing to the shares and debentures of industrial enterprises, underwriting of issues and 'rolling over' of short-term credit. However, after nationalisation, banks have been providing term loans to a limited extent on their own and in participation with term lending institutions. In the case of small borrowers there is a 'composite loan' scheme under which finance, short-term as well as medium and long-term is provided by banks as a package. Till 1978 there was no formal basis of participation of banks in term loans. In pursuance of the recommendation of an Inter-Institutional group appointed by the Reserve Bank in 1978 (known as Bhuchar Committee) the RBI issued certain guidelines which broadly set

out certain parameters within which the banks were allowed to grant term loans. In the post-nationalisation period the amount of term loans provided by banks particularly in favour of small-scale industries and agriculture showed a substantial increase, with the result that the share of term loans in total bank credit showed a persistently increasing trend from around 12 per cent in the early Seventies to about 24 per cent in 1981 (Table 6). The total number of term loan accounts as at the end of December 1981 was 6,51,671 or 41 per cent of the total number of accounts and the amount of term loans outstanding aggregated Rs. 5,790 crores.

Table 6 : Distribution of Outstanding Credit of Scheduled Commercial Banks according to Type of Account

(Rupees Crores)

Type of Account	1973 (end June)	1981 (end June)
Cash Credit	2887	8706
	(50.0)	(40.9)
Overdrafts	464	1415
	(8.0)	(6.6)
Demand Loans	349	1104
	(6.0)	(5.2)
Term Loans	706	5037
	(12.2)	(23.6)
Packing Credit	295	876
	(5.1)	(4.1)
Export Bills Purchased/ Discounted/Advanced against	223	750
	(3.9)	(3.5)
Inland Bills Purchased/Discounted	799	2692
	(13.9)	(12.6)
Advances against Import Bills	48	742
	(0.8)	(3.5)
Total*	5771	21322
	(100.0)	(100.0)

* Relates to accounts with credit limit over Rs. 10,000 .

Note : Figures in brackets are percentages to total.

Source : Banking Statistics : Basic Statistical Returns (Reserve Bank of India).

5.16 While bank credit has grown substantially over the past fifteen years, a matter of some concern is the increase in the level of credit outstanding in respect of sick industrial units, and increase in overdues in the case of rural credit. The outstanding credit to sick industrial units rose considerably from Rs. 956 crores in 1978 to Rs. 1,9f3 crores in 1983. Industry-wise, bank credit to sick units in the textile industry at Rs. 580 crores as at end-June 1983 was the highest, followed by engineering and electricals with Rs. 366 crores, chemicals and sugar with Rs. 209 crores and Rs. 180 crores respectively (Table 7). The percentage share of credit to the sick industrial units in total bank credit to the industrial sector worked out to about 14 per cent as at end-June 1983.

Table 7 : Outstanding Bank Credit to Sick Industrial Units: Industry-wise (End June)

(Rupees Crores)

Industry	1978	1983
Engineering and Electricals	232	366
Iron & Steel	54	142
Textiles	264	580
Chemicals	118	209
Jute	77	121
Sugar	79	180
Cement	14	9
Rubber	25	108
Miscellaneous	93	198
Total	956	1913

Source : **Report on Currency and Finance (Reserve Bank of India).**

5.17 The latest available data pertaining to recovery of direct agricultural advances of scheduled commercial banks reveal that the percentage of recovery to demand as at end-June 1982 was 52.2.

5.18 The various services provided by banks include (i) collection of cheques, demand drafts, bills of exchange, promissory notes, hundis, inland and foreign documentary and clean bills, (ii) purchase of local and foreign currency documentary/clean bills, negotiation of bills under inland and foreign letters of credit, (iii) carrying outstanding instructions of depositors for (a) payment of insurance premia, (b) payment of sub-

scription, (c) payment of certain taxes, (d) gift remittance etc., (iv) providing performance guarantee and financial guarantee, (v) safe custody of deeds and securities,(vi) provision of safe deposit vault facilities (vii) purchase or sale of securities and collection of interest on securities/debentures and dividends on shares, collection of pension bills etc., (viii) remittance of funds through bank drafts, mail transfer and telegraphic transfers overseas and to other parts of the country,(ix) function as executor and trustees,(x) extending assistance in preparing income tax/sales taxes/wealth tax returns,(xi) giving investment facilities such as underwriting and banker to new issues,(xii) sale of units of the Unit Trust of India, and,(xiii) issue of gift cards, travellers' cheques, emergency vouchers etc.

5.19 As regards the resource base of the commercial banks, deposits mobilised from the public constitute the major source of funds accounting for about 90 per cent of the total liabilities, while the share of net worth (paid up capital and reserves) is small and showed a declining trend over the years in the face of the phenomenal growth in deposit liabilities. Presently net worth forms about 1 per cent of the total liabilites. Banks supplement their resources by tapping non-deposit avenues. For instance they avail of the financial accommodation provided by financial institutions, such as IDBI, NABARD, Exim Bank and from the Reserve Bank in the form of refinance and rediscounting facilities. Among the eligible institutions such as the State Financial Corporations, State Industrial Development/Investment Corporations and banks to which the Industrial Development Bank of India extends refinance and rediscount facilities, banks account for about 45 per cent share of the assistance. Similarly 60 per cent of the disbursement by the National Bank for Agriculture and Rural Development, for purposes such as minor irrigation, land development, farm mechanisation, plantation/horticulture, poultry, fisheries, dairy development etc., is routed through the commercial banks. Export-Import Bank of India provides finance for a period of 90 days against export bills to those commercial banks which are authorised to deal in foreign exchange, under its Export Bills Rediscounting Scheme, to enable the banks to fund the post shipment export credit. It also undertakes refinance of term loans for export of Indian capital goods. Reserve Bank's accommodation to commercial banks is in the nature of food credit refinance, export credit refinance, stand-by refinance against pledge of government securities in times of mismatch between sources and uses of funds, and discretionary refinance to tide over temporary financial stringencies. The difference between stand-by refinance and discretionary refinance is that the latter (a) is at the discretion of the RBI, (b) is charged higher rate of interest and (c) need not be secured by pledge of government securities. Borrowings from the call money market constitute another means by which banks in India raise resources.

5.20 As mentioned earlier, on the basis of the form of incorporation and nature of ownership, banks in India could be broadly divided into State Bank of India and its associated banks, set up under the State Bank of India Act, 1955, and the State Bank of India (Subsidiary) Act, 1959 respectively; the twenty commercial banks which are nationalised; private sector banks, Indian branches of foreign banks and Regional Rural Banks. These banks are governed by the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. Pursuant to the enactment of the Banking Laws (Applicable to co-operative societies) Act, 1965 the operations of co-operative banks are also regulated by certain provisions of the Reserve Bank of India Act and the Banking Regulation Act, from March 1, 1966.

5.21 The Reserve Bank's powers to regulate the operations of the commercial banks cover such areas as commencement of business, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Policies relating to deployment of banks' resources, allocation of credit etc.,are laid down by the Reserve Bank of India in consultation with the Central Government and are communicated to the banks through directives issued in terms of the provisions of various Acts, and through guidelines.

5.22 Matters concerning the management of nationalised banks, are the prerogative of the Central Government. In terms of the provision in Nationalised Banks (Management and Miscellaneous Provisions) Scheme 1970/1980, the boards of directors of these banks include an official each from the Government of India and the Reserve Bank and two directors, one representating the workmen staff and the other, the non-workmen staff of the respective banks. The other directors represent the interest of depositors, farmers, workers, artisans or they have special knowledge or experience in the field of accountancy, small-scale industries etc.. The term of office of the above nominated directors, which was earlier for a period of three years (other than the officials of RBI and Central Government) would now be at the pleasure of the Central Government. In the constitution of the boards of directors of the nationalised banks and the State Bank of India the Central Government consults the Reserve Bank of India.

5.23 So far as the management of private sector banks is concerned, they have to ensure that no less than 51 per cent of the total number of members of their board of directors should be persons who have special knowledge or practical experience in one or more fields such as accountancy, agriculture, rural economy, banking, economics, finance, small-scale industry etc.,and practical experience in areas which the bank

considers useful to it. Prior approval of the Reserve Bank has to be obtained in regard to the appointment, reappointment or termination of appointment of the chairman and chief executive officer, of a private sector bank, and the chief executive officer in India of a foreign bank.

5.24 Foreign banks i.e. Indian branches of foreign banks are all scheduled and licensed commercial banks. In pursuance of the policy of social control over banks, foreign banks were urged to constitute Local Advisory Boards as they did not have Boards of Management in India. The constitution of Local Advisory Boards generally conforms to the Scheme of Social Control as it applied to the Boards of Indian banks. With the reorientation of credit policy, foreign banks are expected to help in the financing of neglected sectors like small-scale industry, small business, self-employed persons etc., to the extent possible. As regards assisting the agricultural sector these banks can provide finance only indirectly by subscribing to the debentures of land development banks, granting advances to other land development agencies, financing distribution of chemical fertilisers/pesticides/agricultural equipment etc.. The banks are also expected to endeavour to enlarge the scope of their export finance for promotion of Indian exports as also of foreign currency loans for industrial projects in India.

5.25 **Generally, the organisation of banks involves a three-tier structure, viz., the Head Office, the Regional/Zonal offices and the branches. The** Head Office is divided into various departments for administrative convenience and operational efficiency. The Regional Office/Zonal Office exercises direct supervision and control of the branch offices and are expected to play a triple role of (a) development of business in their respective regions, (b) supervision and control over the working of branches under their charge, and (c) communication with the Head Office on important matters concerning the branches and the regions. How much direct control over the working of the branches should be exercised by the Head Office, and how much by the Regional/Zonal offices is a matter of policy. Presently powers are delegated to the Zonal offices to the maximum extent possible in order to avoid multiplicity of control and ensure prompt disposal of cases.

5.26 In exercise of the supervisory powers derived from the Banking Regulation Act and the Banking Laws (Applicable to Co-operative Societies) Act,the Reserve Bank conducts periodically inspection of the operations of banks. The objective of bank inspections conducted by the Reserve Bank of India is the promotion of a sound banking system in the country in conformity with the banking laws and regulations as well as the socio-economic objectives. The inspections are designed to serve as a tool

of overall appraisal of the financial/managerial system and performance of banks, and contribute towards streamlining of their procedures and methods of operation, prevention of irregularities etc. Banks are inspected to ensure that declared policies of the government and the Reserve Bank of India are being implemented. The inspections cover the banks' organisational set-up, branch expansion, mobilisation of deposits, investments, credit portfolio management, credit appraisal, control and reporting system, region-wise performance, profit planning and man-power planning and training. The Reserve Bank has powers to inspect foreign branches of Indian banks in order to enquire whether they are working on sound lines and on a profitable basis. In order to review the working of the public sector banks on an annual basis, the Reserve Bank introduced the 'Annual Appraisal' in 1978. In this appraisal, which is in the nature of management audit, emphasis is laid mainly on the examination of organisational set-up, man-power planning, funds management and management of credit etc.

5.27 The control over expansion of banks' branches constitutes a method by which the Reserve Bank exercises its supervisory powers. Statutory powers in this regard conferred by the provisions of the Banking Regulation Act stipulate that the banks should obtain permission from the Reserve Bank for opening new places of business in India and in certain cases, for changing the location of their existing offices and for opening temporary offices, administrative office etc. Before granting permission the Reserve Bank has to satisfy itself of the soundness of the financial condition and management of the applicant bank, adequacy of capital structure, earning prospects, and in general satisfy itself that the public interest would be served by the opening of the branch or change of location. The main objective of licensing policy is to widen in a systematic manner, the spread of banking facilities to all potential unbanked centres, particularly to areas which are deficient in banking facilities. After the nationalisation of the major banks the thrust of branch licensing policy was on opening of branches on a liberal basis, particularly in rural and semi-urban areas so as to bring about a balanced growth of banking in all regions.

5.28 The comprehensive branch licensing policy formulated in 1978 covering the period 1979-81 kept in view such factors as the emphasis given to rural development, dispersal of industries and development of small-scale industries. In terms of this policy banks were asked to concentrate their attention on opening of branches in rural and semi-urban areas of 225 districts, which were identified as deficient in banking facilities in relation to the national average of 20,000 population per bank office as at the end of June 1978. District-wise plans for branch expansion were

drawn up in respect of all the States in the country in consultation with the State Governments and banks. Top priority was given for opening of bank branches in all the community block development headquarters in the country. The lead banks were given preference for opening additional branches in their lead districts. Banks having a regional character were required to concentrate on opening branches in their own areas of operation. Following the termination of the branch licensing policy for the period 1979-1981, a new policy for the period April 1982 to March 1985 was evolved in consultation with the Government of India in the light of progress made and experience gained. The policy laid continued emphasis on enlarging banking facilities in rural and semi-urban areas and reducing the inter-regional disparities. The aim was to attain a coverage of one bank office on an average for a population of 17000 in rural and semi-urban areas. State Governments were asked to identify the centres in rural and semi-urban areas suitable for opening bank offices. Expansion in urban and metropolitan centres would continue to be on a selective basis.

5.29 An important scheme designed to promote the banking habit is the insurance of bank deposits. The need for a machinery to offer protection to bank depositors, particularly small depositors, in the context of the risk of loss of savings of the community following bank failures, resulted in the establishment of the Deposit Insurance Corporation in 1962 under the Deposit Insurance Corporation Act 1961, as a wholly owned subsidiary of the Reserve Bank of India. Under the Act all commercial banks including Regional Rural Banks (and Co-operative Banks in States where the Act has been made applicable to the co-operative banks by the concerned States) are registered as insured banks in order to provide uniform protection to all bank depositors.

5.30 Every depositor of an insured bank which goes into liquidation is entitled to receive from the Corporation through the liquidator, repayment of his deposits in all branches of that bank upto a maximum limit prescribed from time to time; the ceiling which was Rs. 1,500 at the beginning of the scheme is at present Rs. 30,000. The amount of deposit for this purpose is determined after deducting any dues by the depositor to the bank. The banks have to bear premium of 4 paise per annum for every Rs. 100/– of the total assessable deposits with the bank. Under the Deposit Insurance and Credit Guarantee Corporation Act the functions of deposit insurance and credit guarantee were integrated. Effective July 1978, the Deposit Insurance Corporation took over the Credit Guarantee Corporation of India Ltd., which had been providing a wide ranging system of guarantees in respect of loans granted by the credit institutions to small borrowers. Consequently the corporation was renamed as Deposit Insurance and Credit Guarantee Corporation.

Table 8 : Distribution of Outstanding Loans and Advances of Scheduled Commercial Banks According to Interest Range, and Occupation

(End June 1981)

(Rupees Lakhs)

Occupation	6% & less	Above 6% – 10%	Above 10% — 12%	Above 12% — 14%	Above 14% — 15%	Above 15% — 16%	Above 16% — 17%	Above 17% — 18%	Above 18% — 20%	Above 20% — 22%	Above 22% — 24%	More than 24%	Total Loans and Advances
Agriculture	1746	20758	82950	47137	14656	4948	11843	24776	25009	208	1	50	234082
Small Scale Industry	2862	3544	32759	74752	34682	26951	27709	22219	27468	864	15	162	253987
Transport Operators	416	513	57770	31455	8746	2774	3186	2667	6301	356	23	21	114228
Personal & Professional Services	560	780	2986	8561	5459	3026	2693	1882	9199	500	3	6	35655
Retail Trade	423	546	2605	9333	7217	2073	4051	2246	21262	504	4	14	50280
Sub-Total	6007	26141	179070	171238	70760	39772	49482	53790	89239	2432	46	253	688232
	(0.9)	(3.8)	(26.0)	(24.9)	(10.3)	(5.8)	(7.2)	(7.8)	(13.0)	(0.3)	(–)	(–)	(100.0)
Other Sectors	31608	27433	89092	241979	52829	41606	50187	113073	371935	5399	210	137	1025486
	(3.1)	(2.7)	(8.7)	(23.6)	(5.2)	(4.0)	(4.9)	(11.0)	(36.3)	(0.5)	(–)	(–)	(100.0)
Total	37615	53574	268162	413217	123589	81378	99669	166863	461174	7831	256	390	1713718
	(2.2)	(3.1)	(15.7)	(24.1)	(7.2)	(4.8)	(5.8)	(9.7)	(26.9)	(0.5)	(–)	(–)	(100.0)

Note : 1. Relates to accounts with credit limit over Rs. 10,000.

2. Figures in brackets are precentages to total.

Source : Banking Statistics : Basic Statistical Returns (Reserve Bank of India).

5.31 The concept of credit planning which was formally introduced as a part of the measures of social control over banks initiated by the Government of India in 1967-68, received renewed attention after the enlargement of government control over the banking system. The basic objective of credit planning is to guide investment and output along the lines envisaged in the Five Year Plans. This involves estimation of credit expansion with reference to the various aggregative and sectoral targets laid down in the Five Year Plan. This exercise implies not only the regulation of the overall level of credit expansion but ensuring that such expansion is in consonance with the sectoral needs in terms of production plans. Thus credit planning is concerned with both dimensional and directional changes in bank credit.

5.32 An analysis of the different rates of interest charged to different categories of borrowers showed that over 52 per cent of total loans and advances outstanding at the end of June 1981 were at interest rates of 15.0 per cent or lower. The amount lent at 10 per cent interest or less formed 5.3 per cent of the total while it accounted for 9.6 per cent in the case of the agricultural sector. About 27 per cent of lending was at 18 per cent or higher rates of interest. The maximum lending rate prescribed by the Reserve Bank was 19.5 per cent with effect from March 2, 1981 as against 18 per cent effective September 13, 1979. Presently the maximum lending rate is 17.5 per cent.

5.33 As regards interest rates on deposits, the Reserve Bank has been regulating these rates since September 1964 (for a short period between September 1960 and February 1961 the Bank did peg the rate on deposits upto 21 days). Prior to 1964 the deposit rates were governed by voluntary agreement amongst the major Indian and foreign banks. The rates on fixed deposits of various maturities and savings bank deposits have been subjected to many revisions since 1964. In June 1977, the structure of interest rates on deposits, was rationalised and the spread between short and long-term rates was widened. Drawing a distinction between saving-oriented savings deposits and transactions-oriented savings deposits two types of such deposits were introduced in July 1977; the interest rate on savings deposits without cheque facilities was 5 per cent per annum while those with cheque facilities earned a lower rate of 3 per cent. However, on March 1, 1978 the two accounts were merged into a single savings deposit account and the interest rate on these deposits was fixed at 4.5 per cent. At the same time deposit rates were reduced marginally, particularly in the case of deposits of longer maturity, with a view to ensuring an even spread between the rates on short, medium and long-term deposits. Subsequently in October 1977 and March 1981, the rates were revised upward in respect of certain categories of fixed deposits. In March 1981, rates on deposits with shorter maturities of less than 3 years was increased. With a view to

offering a better rate on savings in the form of longer term bank deposits as also to assist banks in their deposit mobilisation efforts, in November 1982 the RBI reintroduced the category of term deposits of five years and above which would attract a rate of 11 per cent. The revision in interest rate was in pursuance of the recommendation of the Working Group on Bank Deposits set up by the Reserve Bank to examine the trends in the growth of bank deposits and review the interest rate structure in respect of bank deposits and existing regulatory framework regarding deposit mobilisation. The other measures taken by the Reserve Bank in the light of the Group's recommendations are:(1) In the case of premature withdrawal of term deposits the interest payable on such deposits would be 1 per cent below the rate applicable to the deposit for the period during which the deposit had remained with the banks. (2) The interest to be paid on premature withdrawal or renewal under reinvestment plan (which provides for reinvestment of interest) would be compound interest with quarterly rests at the prescribed rate as against simple interest allowed earlier. (3) Depositors having balances in Janata Deposit (daily deposit) and recurring deposit accounts would be allowed to convert the balances with compound interest and without penalty to fixed deposit accounts before maturity. (4) In the case of balances lying in current account in the name of a deceased depositor, interest would be paid at savings bank deposit rate on and from the date of death of the depositor till payment to the legal heirs. (5) Banks are generally prohibited from paying interest on savings accounts opened in the name of a trading/business concern. However, certain agencies like the Small Farmers Development Agency and Marginal Farmers and Agricultural Labourers Agency (in view of the socially desirable purposes of their activities), societies registered under the Societies Registration Act, 1860 or any corresponding State laws and companies licensed under Section 25 of the Companies Act, 1956 were allowed to open savings bank accounts on the usual terms. Institutions which are not liable to pay income tax under the Income Tax Act, 1961 have also now been included in this exempted category.

5.34 Effective April 8, 1985, the Reserve Bank allowed the banks freedom to determine interest rates on deposits of less than one year maturity subject to the rates being not higher than 8.0 per cent. The interest rate on deposits of maturity of one year and above but less than two years was raised from 8.0 per cent to 8.5 per cent.

5.35 From time to time the Reseve Bank has been initiating a series of measures designed to impose a degree of discipline in credit use particularly among the large borrowers and consequently to regulate the demand for credit from different sectors of the economy. Important among them are the Selective Credit Control, the Credit Authorisation

Scheme, prescription of norms in regard to inventory holding and receivables as recommended by the Study Group to frame Guidelines for Follow up of Bank Credit (Tandon Committee) and the Working Group to Review the system of Cash Credit (Chore Committee). These are discussed in Chapter 11 of the Report.

5.36 An important aspect of bank credit is the involvement of banks in financing exports. In recognition of the important role that exports are to play in the Indian economy, special attention has come to be bestowed on the provision of export credit at concessional and liberal terms. Exporters are provided pre-shipment credit to enable them to purchase raw materials, process and manufacture goods and transport them in terms of their contract with the overseas buyers. Exporters are generally required to lodge with the bankers, letters of credit or sale contracts or cable confirmation of sale. The credit is granted for a minimum period of 90 days and a maximum period of 180 days unless extended with Reserve Bank of India's prior approval, and is liquidated from the proceeds of relative bills purchased, negotiated or discounted by the banker. The banks are asked to treat each pre-shipment advance as a separate loan account. Advances are also made to exporters in order to meet the commitments during the interval between the date of shipment of goods and the date of realisation of sale proceeds. This 'post-shipment credit' is extended by purchase of demand foreign bills, discounting foreign usance bills or, by making advances against foreign bills sent for collection. Another measure aimed at export promotion is the Duty Draw-back credit scheme. Under this scheme which came into force from February 1976, bank credit is provided to exporters against duty draw-back entitlement as provisionally certified by customs authorities.

5.37 The maximum rate of interest chargeable for export credit by banks has been prescribed both in respect of pre-shipment credit and post-shipment credit; the rate is lower than the maximum lending rate for other advances. With a view to ensuring that the lower ceiling rate does not act as a disincentive for providing necessary finance to exporters, and to compensate partially the loss in interest earnings, the banks are being granted a subsidy of 1.5 per cent by the Government of India under the Export Credit (Interest subsidy) Scheme 1968, effective March 1968. The subsidy is payable in respect of all types of export credit provided by the banks except those refinanced by Export Import Bank of India. The funds for the subsidy are provided from Government of India's (Commerce Ministry) Marketing Development Assistance Fund. Working Capital advances granted by way of packing credit by the co-operative banks to the exporters, were brought within the purview of the scheme in 1973.

5.38 Overall trends in total business, working funds, earnings, expenses and profit pertaining to commercial banks are reflected in the data presented in Table 9. The data reveal that the volume of business, working funds, earnings, expenses and profits during the period 1970-1980 recorded a significant growth. However, the break up of growth rates of these items between the first five year period 1970-75 and the second half (1975-80) of the period presents a perceptible contrast between the two periods.

Table 9 : Growth of Banking Operations
(Commercial banks)
compound annual growth rate (per cent)

Period	Total Business	Working Funds	Total Earnings	Total Expenses	Balance of Profit
Ten Year Period (1970-80)	19.5	20.1	24.7	24.9	22.8
Five Year Period (1970-75)	18.1	18.8	27.7	27.2	26.7
Five Year Period (1975-80)	20.5	21.6	16.3	22.1	13.7

Note : 1) Total Business = Average deposits + Average credit.
2) Working funds = Average deposits + Average borrowings.
Source :-Statistical Tables Relating to Banks in India (Reserve Bank of India).

5.39 The annual compound growth rate of working funds in the second period (1975-80) at 21.6 per cent was higher than the increase of 18.8 per cent in the first period (1970-75). The total business grew correspondingly at 20.5 per cent in the second period as against 18.1 per cent in the first period.

5.40 It would be noticed that earnings, and expenses registered a substantially faster growth rate than that of working funds and total business during the first period. The growth rate of earnings at 27.7 per cent was slightly higher than the growth of expenses at 27.2 per cent during the first period. The impact of these growth rates in earnings and expenses was reflected in the growth in the balance of profit of 26.7 per cent during the first period.

5.41 In sharp contrast, the annual compound growth rate of earnings at 16.3 per cent during 1975-80 was much lower than that of expenses at 22.1 per cent and did not keep pace with the growth of total business and working funds. Consequently the growth rate of balance of profit came down sharply to 13.7 per cent during 1975-80.

Table 10 : Earnings of Scheduled Commercial Banks

(Rupees Crores)

Year ending December	Interest earnings etc.*	Earnings from other services	Total current operating earnings
1969	361 (86.2)	58 (13.8)	419 (100.0)
1970	445 (88.1)	60 (11.9)	505 (100.0)
1971	561 (88.2)	75 (11.8)	636 (100.0)
1972	653 (88.4)	86 (11.6)	739 (100.0)
1973	806 (88.7)	103 (11.3)	909 (100.0)
1974	1154 (89.5)	136 (10.5)	1290 (100.0)
1975	1509 (88.1)	204 (11.9)	1713 (100.0)
1976	1882 (87.0)	282 (13.0)	2164 (100.0)
1977	2258 (87.7)	317 (12.3)	2575 (100.0)
1978	2544 (87.4)	368 (12.6)	2912 (100.0)
1979	3134 (87.3)	457 (12.7)	3591 (100.0)
1980	4104 (87.7)	573 (12.3)	4677 (100.0)
1981	5524 (89.1)	676 (10.9)	6200 (100.0)

* Includes dividend, commission and exchange earnings

Note : 1. Figures in brackets are percentages to total.

Source : Statistical Tables Relating to Banks in India (Reserve Bank of India).

5.42 The slower growth of earnings as compared to total business and working funds could partly be attributed to the rising proportion of low yielding assets such as investments in government securities, food credit, and priority sector advances during 1975-80. The rising proportion of high cost deposits and also the increase in operating cost contributed to faster growth of expenses as compared to that of earnings.

5.43 An analysis of the composition of earnings of banks indicates that the share of interest earnings, commission etc. in total earnings accounted for 89 per cent in 1981 while the earnings from other services amounted to 11 per cent. It would be seen that over the period 1969-81 the share of the former rose marginally while the share of ernings from other services in the total showed a decline (Table 10).

5.44 Among expenses, the most important constituent had been interest expenses, followed by establishment expenses and other expenses. It would be noticed that interest expenses as a per cent of total current operating expenses ranged between 50 to 61 per cent of total expenses upto 1976. In the subsequent years this proportion showed a continuous rise. At the end of December 1981, the percentage share of interest expenses accounted for about two third of the total current operating expenses. This could mainly be attributed to upward revisions and some adjustments in the deposit rate structure during the period. The reason for the increase in the proportion of interest expenses component in total current operating expenses lies not only in the higher rates paid on deposits but also in the change in the composition of deposits resulting from a pronounced shift to deposits of longer maturity bearing higher deposit rates on the one hand and in the change in the composition of working funds of banks on the other (Table 11). Consequent to these shifts in the composition of working funds, the interest expenses of banks rose substantially in recent years.

5.45 The share of establishment expenses in total current operating expenses declined steadily from 39 per cent in 1970 to 22 per cent in 1981. The larger share of establishment expenses in the total expenses upto 1976 was attributable to faster branch expansion on the one hand and the time taken to achieve a sustained deposit growth in the new branches on the other. The spurt in interest expenses since 1975 relative to establishment expenses partly reflects the upward revision of interest rates offered on deposits. The other operating expenses more or less remained stable around 11 per cent during the most part of the period under review.

5.46 The data on earnings and expenses of all scheduled commercial banks as percentage of current operating earnings presented in Table 12 indicate that the percentage share of earnings from advances declined

Table 11 : Expenses of Scheduled Commercial Banks

(Rupees Crores)

Year ending December	Interest Expenses, Commission etc.	Establishment Expenses	Other Expenses	Total current Operating Expenses
1969	190	141	43	374
	(50.8)	(37.7)	(11.5)	(100.0)
1970	226	180	50	456
	(49.6)	(39.5)	(10.9)	(100.0)
1971	287	216	62	565
	(50.8)	(38.2)	(11.0)	(100.0)
1972	346	248	75	669
	(51.7)	(37.1)	(11.2)	(100.0)
1973	446	306	88	840
	(53.1)	(36.4)	(10.5)	(100.0)
1974	665	395	109	1169
	(56.9)	(33.8)	(9.3)	(100.0)
1975	859	481	223	1563
	(55.0)	(30.8)	(14.2)	(100.0)
1976	1189	480	270	1939
	(61.3)	(24.8)	(13.9)	(100.0)
1977	1467	556	309	2332
	(62.9)	(23.8)	(13.3)	(100.0)
1978	1709	656	255	2620
	(65.2)	(25.0)	(9.8)	(100.0)
1979	2159	826	273	3258
	(66.3)	(25.3)	(8.4)	(100.0)
1980	2789	1004	423	4216
	(66.2)	(23.8)	(10.0)	(100.0)
1981	3601	1191	608	5400
	(66.7)	(22.0)	(11.3)	(100.0)

Note : Figures in brackets are percentages to total.
Source : Statistical Tables Relating to Banks in India (Reserve Bank of India).

Table 12 : Earnings and Expenses of Scheduled Commercial Banks
(As a percentage of Current Operating Earnings)

Year ending December	Current Operating Earnings				Current Operating Expenses			
	Adances	Govern-ment Securities	Other Invest-ments and Deposits	Other Earnings	Establish-ment Expenses	Interest on Deposits	Interest on Borro-wings & other Accounts	Other Expenses
1973	69.8	13.7	5.1	11.3	33.6	46.5	2.6	9.7
1974	74.9	8.8	5.8	10.5	30.6	45.6	5.9	8.5
1975	73.8	9.0	5.3	11.9	28.1	45.9	4.2	13.0
1976	72.0	10.1	4.9	13.0	22.2	46.5	8.4	12.5
1977	70.7	11.5	5.5	12.3	21.6	49.2	7.8	12.0
1978	67.2	13.7	6.4	12.7	22.5	52.6	6.1	8.8
1979	66.1	12.3	8.9	12.7	23.0	52.9	7.2	7.6
1980	66.4	8.8	12.6	12.2	21.5	52.2	7.5	9.0
1981	66.0	8.5	14.6	10.9	19.2	49.5	8.5	9.8

Source : Statistical Tables Relating to Banks in India (Reserve Bank of India).

steadily from 75 per cent in 1974 to 66 per cent in 1979. This proportion stabilised around 66 per cent in the subsequent years 1980 and 1981.

5.47 The trends in earnings and expenses discussed above have a decisive bearing on the balance of profit of banks. Earnings, expenses and balance of profit of a bank are governed by several factors, some of them endogenous to the system, some exogenous to the system, apart from structural factors. Policy parameters are exogenous to the system and they include changes in quantitative credit controls like credit targets, Cash Reserve Ratio, Statutory Liquidity Ratio and qualitative credit controls like selective credit control measures, norms relating to credit-deposit ratios (state-wise/population group-wise), guidelines regarding priority sector advances, advances under Differential Rate of Interest Scheme, administered interest rates, levy of interest tax etc. Certain other factors like efficient management of working funds, ratio of operating expenses to the total business handled, ratio of idle assets to total earning assets, recovery of dues, and decentralisation and other aspects of overall management of banking operations are endogenous factors affecting profitability of banking operations. The geographical expansion, functional diffusion and the changes in the pattern of deposits and other loanable funds are some of the structural factors. Admittedly, there are a host of factors affecting interest spread and profits of banks.

5.48 An important factor which also influences the balance of profit of some of the Indian scheduled commercial banks is the performance of their foreign branches. As of June 1984 the number of these offices operating in 25 countires reached 141 as against 58 at the close of 1970 (Table 13). Among the new offices opened abroad, the number of offices opened in U.K. was the largest followed by Hong Kong, United Arab Emirates, U.S.A. and Mauritius.

Table 13 : Indian Commercial Banks' Offices Abroad

End December	No. of Offices
1970	58
1975	77
1978	121
1981	135
1984 (June)	141

Sources : Statistical Tables Relating to Banks in India, and Report on Trend and Progress of Banking in India (Reserve Bank of India).

5.49 The selected ratios presented in Table 14 show that the foreign offices had a relatively lower proportion of cash and investments. The cash-deposit ratio of 2.8 per cent and investment deposit ratio of 6.1 per cent in respect of business abroad were considerably lower than those in India at 12.3 per cent and 33.8 per cent respectively in 1981. Further, the credit-deposit ratio in the case of foreign offices in 1981 was much higher than that of scheduled commercial banks in India. These features of business abroad might have in part helped some of the banks with foreign offices to earn a higher level of profit in recent years.

5.50 The concept of operational efficiency of a commercial bank in India is associated with such diverse aspects of its operations as cost effectiveness, profitability, customer services, priority sector lending, mobilisation of deposits and deployment of credit in the rural and backward regions and so on. Operational efficiency in banking has thus attained a wider connotation. Precisely for this reason, a generally acceptable definition of the concept, and selection of appropriate indicators are beset with difficulties. Nevertheless, improvement in productivity in all aspects of banking operations has to be pursued by banks as an important management objective as it vitally affects the efficiency of the monetary system.

5.51 As noted earlier, during the period 1969-84 the banking system in India witnessed a phenomenal geographical expansion and functional diversification. Consequently, the number of branches, as also deposits and credit grew significantly. The number of bank customers, transactions and inter-bank transfers increased correspondingly. As at the end of 1980, the banking system had more than ten million customers with an estimated three million transactions and one million inter-branch transfers per day. These rapid developments have placed a severe strain on the organisational resources of banks. As a result, customer service, house keeping, husbanding of bank resources, internal control and supervision have tended to deteriorate.

5.52 The information systems have become inadequate in the light of the current internal needs of bank management. Besides, numerous additional statistical returns are called for by the Reserve Bank of India and the government, following the need to monitor various lending programmes and these have increased the load on the information system. The Subbarao Committee which measured the productivity of banks in terms of delay in balancing of books and late submission of returns suggested that computerisation was the only solution to the problem.

5.53 The three working groups of the Reserve Bank of India on (i) Accounting Procedures and Maintenance of Branch Level Records,

Table 14 : Selected Operating Ratios of Scheduled Commercial Banks.

(per cent)

	1970	1981
Cash-Deposit Ratio		
Indian Business	6.3	12.3
Business Abroad*	4.6	2.8
Credit-Deposit Ratio		
Indian Business	78.3	66.9
Business Abroad *	56.3	84.8
Investment-Deposit Ratio		
Indian Business	30.4	33.8
Business Abroad *	18.3	6.1

* Relates to Indian scheduled commercial banks.

Note : Ratios pertain to the last Friday of December.

Source : Statistical Tables Relating to Banks in India (Reserve Bank of India).

(ii) Review of Working of Lead Bank Schemes, and (iii) Role of Banks in Implementation of New Twenty Point Programme arrived at the conclusion that mechanisation was inevitable for developing a speedy information system. The recent report of the Committee on Mechanisation in Banking Industry contains an in-depth study of the issues relating to mechanisation. Stressing the need for a degree of mechanisation for efficient discharge of basic functions like customer service, the Committee recommended that "the process of mechanisation should encompass activities at the branch, regional and head office levels with emphasis varying from one level to another". We are broadly in agreement with this approach.

Role of Financial Institutions in the Non-Banking Sector

5.54 The traditional deposit accepting agencies in the informal financial sector provide, particularly to the informal sector, services akin to those provided by the banking system. In view of this, the role of these institutions as an adjunct to the formal banking system is discussed in the subsequent paragraphs.

5.55 At the outset it may be noted that units in the corporate sector accept deposits from the public and the funds so obtained are used by them to finance their own operations and not for on-lending. These units are generally referred to as non-banking non-financial companies. The deposit taking activities of such companies which are mainly manufacturing and trading companies in the non-banking corporate sector, are governed by the Companies (Acceptance of Deposits) Rules, 1975, issued by the Department of Company Affairs.

5.56 The acceptance of deposits by the non-banking financial companies, either private limited companies or public limited companies, is governed by the directions issued by the Reserve Bank of India.

5.57 In the case of unincorporated bodies such as individuals, firms and unincorporated association of individuals, the deposit taking activity is prohibited, except to a limited extent, with the commencement of the provisions of Chapter III C of the Reserve Bank of India Act with effect from 15th February 1984. Under these provisions an individual cannot accept deposits from more than 25 persons excluding those who are relatives. Similarly, a partnership firm or an unincorporated association of individuals is prohibited from accepting deposits from more than 25 depositors per partner/individual and from more than 250 depositors in all, excluding in either case, depositors who are relatives of any of the partners/individuals. No ceiling is placed on the amount of deposit per depositor.

5.58 The intention behind putting a limitation on the number of depositors instead of on the quantum of deposit is mainly to prevent the free access of unincorporated bodies to the members of the public at large and at the same time, allow such of the concerns as are in need of large funds to approach a limited but known circle for meeting their financial requirements. Deterrent penalty for non-compliance has also been provided. Under these provisions concurrent jurisdiction has been vested in the State Government/Union Territory besides the Reserve Bank to initiate action against offenders.

5.59 In the light of the above, non-banking financial companies and the non-banking, non-corporate deposit accepting agencies may together be referred to as non-banking financial intermediaries (NBFI). A brief description of the activities of the different forms of non-banking financial intermediaries (NBFI) is given in Annexure 5.2.

5.60 Emergence and growth of non-banking financial intermediaries could be traced to the need for provision of finance to activities which were not served by the organised banking system as also to a class of customers whose demands were not fully satisfied. The phenomenal growth in commercial banking business both functionally and geographically which has been in evidence since early Seventies did not hamper the activities of non-banking financial intermediaries who expanded their business, and in a sense supplemented the activities of commercial banks. The non-banking companies which are engaged in accepting deposits could be broadly grouped into non-banking non-financial companies (mostly manufacturing and trading companies) who mobilise deposits for the purpose of financing their own business activities, and the non-banking financial companies who accept deposits for the purpose of lending and investment. Table 15 shows the trends in deposits mobilised by these two groups of companies in recent years.

5.61 There has been a notable growth in the funds mobilised by the financial as well as the non-financial companies in absolute terms. At Rs. 1,977 crores at the end of March 1983 their deposits were nearly twice as high as the level in March 1979. As a proportion of GDP these deposits amounted to 1.37 per cent in March 1983 as against 1.15 per cent in 1979. Trading and manufacturing companies form the major part of non-banking non-financial companies which accounted for about 88 per cent of these deposits and the share of non-banking financial companies was only 12 per cent.

5.62 The growth in deposits of non-banking financial companies which as a proportion of GDP stood at less than 0.2 per cent has been at a

Table 15 : Trends in Deposits of Non-Banking Companies

(Rupees Crores)

Outstanding as at the end of March	Total Deposits with Non-Banking Companies@	Deposits with	
		Non-Banking Non-Financial Companies	Non-Banking Financial Companies
1978-79	1002	847	155
1979-80	1072	885	187
1980-81	1357	1142	215
1981-82	1520	1306	214
1982-83	1977	1740	237

@ Exclude both exempted deposits and regulated deposits.

Source : Survey of Deposits with Non-banking Companies, Reserve Bank of India Bulletin.

slower pace than that noticed in the case of the other category. The rise in the deposit liabilities of non-banking non-financial companies has been quite marked since 1980-81.

5.63 The quantum and the order of increase in resources mobilised by the non-banking companies cannot be considered to be significant when compared with the deposits mobilised by banks which were of the order of 34 per cent of GDP in 1982-83. The growth of deposit accepting agencies other than commercial banks has been thought of as a development which might tend to reduce the rate of growth of bank deposits. A rapid growth of a wide variety of non-banking financial intermediaries at various stages of economic development implies that money supply, defined narrowly as currency with the public and their demand deposits with banks or broadly to include also time deposits of the public, becomes a smaller proportion of financial assets. In the Indian context where there are no close links between banks and the non-banking financial intermediaries, such a shift tends to reduce the area of operation of monetary regulation measures. Further, availability of funds to spending units from sources outside the purview of credit control measures of monetary authorities tends to reduce the efficacy of any restrictive monetary policy pursued by the central bank. As against these factors, it is also to be recognised that the non-banking financial intermediaries have traditionally been meeting some of the credit needs of the informal sector and their operations are governed by long standing conventions and practices. These aspects of the working of the NBFI's need to be borne in view in assessing their role as an adjunct to the formal banking system.

5.64 A detailed study of the different aspects of the functioning of the non-banking financial intermediaries commissioned by the Committee supports the conclusions presented in the following paragraphs.

5.65 Chit funds have established themselves as a non-banking financial intermediary in South India. Total deposits of chit funds amounted to about Rs. 229 crores at the end of March 1983 as indicated in a study made by the Reserve Bank. The subscriptions flow only to members who use it mostly for consumption purposes. The chit funds, thus, are in the nature of a consumer finance institution. They generate gross savings and provide a source of borrowing to people of limited means. Since 1982 they are governed by the Chit Funds Act and hence are under a suitable regulatory framework.

5.66 Nidhis are purely local institutions which accept deposits from

members and restrict their lending to members. Their interest rates both for deposits and on loans are comparable to those of the commercial banks, and their lending is against security such as landed property, gold and jewellery. They enjoy some popularity in the community because of their easy accessibility and absence of restrictions on the use of their loans. The total amount of deposits with them is very small (about Rs. 36 crores in 1983) and their growth has been very slow. They work on sound principles of banking, and their operations are similar to those of unit banks. They are governed by directions from the Reserve Bank as they are incorporated bodies.

5.67 Finance corporations are the largest financial intermediary among the non-banking financial intermediaries, accounting for deposits of about Rs. 1,714 crores at the end of March 1983*, and their business is concentrated mainly in the Southern States. Their operations are akin to banking. In the mobilisation of savings, they offer some competition to banks. Their interest rates both for deposits and on loans are high and depend on the supply and demand for funds. Generally they pay a high rate of interest to the savers. A considerable part of the amount they lend flows to channels not preferred by commercial banks. They finance the film industry including theatre construction and film production, construction of buildings, acquisition of real estate and personal consumption. They also provide financial assistance to trade and business and meet the requirements of those who are unable to get accommodation from banks due to various reasons. Thus, in some respects their lending operations might run counter to the official credit policy but they also assist the clients of banks in bridging the gap in financial requirements left uncovered by banks. Clearly their services are sought as there is a gap between the demand for, and supply of bank credit, and there also is a time lag between their request for credit facilities and the sanction of credit facilities by a bank. As such, the assistance provided by the finance corporations cannot always be construed as unproductive. The main argument in favour of the finance corporations is that they operate in a market outside the banking system to the convenience of certain borrowers and savers. Regulation of their deposit and lending rates will destroy the *raison d'etre* of such corporations which are in the nature of para-banking agencies. Regulation should, therefore, seek to curb that part of their activities which are not in conformity with official credit policy but not that which genuinely helps trade.

5.68 Hire purchase finance institutions provide an useful service to industrial units by facilitating the sale of durable consumer goods and

* Reserve Bank of India Bulletin, July 1984.

other industrial products, and to the economy in general through assisting a large number of transport operators who help in the movement of goods and passengers. About one half of the hire purchase institutions is in the corporate sector while the other half is in the non-corporate sector. The hire purchase finance institutions in the non-corporate sector need to be encouraged by policy measures to become companies.

5.69 A system of licensing appears to be essential to protect the interest of depositors of the non-banking financial intermediaries, and a suitable cut off point, taking into account their large numbers, and administrative considerations, may be laid down in regard to the level of their business beyond which they will be under a legal obligation to obtain a licence.

Chapter 6 : RESERVE MONEY AND MONEY SUPPLY

The choice of monetary policy instruments for regulating the money stock in the economy is dependent on the appropriate definition of money, the money supply process, i.e. the process by which the stock of money gets created, and the influence of money on output and prices.

6.2 **Definition of money supply:** Money has been traditionally defined as the sum of currency with the public and that portion of the deposits held by the public with banks which are withdrawable on demand. Money so defined is referred to as M_1 or narrow money. A broader concept of money includes, apart from currency, all deposits held by the public with the banks irrespective of whether they are withdrawable on demand or not. Broad money is also referred to as M_3. The definition of money has, however, several other variants. Most central banks have found that it would be useful to work with more than one definition of money supply in devising policies for regulation of money supply. The concept of money supply has undergone changes over the years reflecting the trend of economic thinking in this regard.

6.3 The Working Group on Money Supply set up by the Reserve Bank in 1961 provided the framework for the definition and analysis of money supply in India. Money supply with the public was defined as consisting of (i) currency notes and coins with the public, (ii) demand deposits (excluding inter-bank demand deposits) of scheduled and reporting non-scheduled banks and State co-operative banks, and (iii) deposits (generally referred to as 'other deposits') held with the RBI, in current account by central banks of other countries, financial institutions and quasi-financial bodies other than banks, and by the International Monetary Fund other than balances in its Account No. 1. This definition corresponded to the narrow definition of money supply. It may be noted that while deposits of government with banks if any are part of 'deposits of the public', its holdings of currency at treasuries are excluded from 'currency with the public'. Further, inter-bank deposits are not included in money supply (corresponding to M_1) as defined. The Working Group also suggested that money supply with the public as defined by them together with time deposits (other than inter-bank time deposits) with banks gave a more meaningful indication of the role of money in economic activity. The Reserve Bank started publishing this broader aggregate from 1964 under the head 'Aggregate Monetary Resources'.

6.4 The Second Working Group on Money Supply was set up by RBI in 1977 to examine the suitability of various concepts and definitions of money supply, suggest methodological changes for compilation so as to bring out the significance and implication of these data for policy formulation and depending on the results of the examination of the various issues involved, prepare a revised time series of money supply as well as factors affecting it. The Working Group found it useful (i) to have a variety of monetary aggregates since the use of a single measure of money stock for monetary analysis and policy would be inadequate and at times even misleading, and (ii) to improve the data base of the monetary sector in terms of both coverage and sophistication. The coverage has been improved by the Working Group by including the deposits of all the co-operative banks and the salary earners' societies. Four measures of money stock viz. M_1, M_2, M_3 and M_4, as defined below have also been made available from 1971, deposits with post offices also being covered in the definitions of M_2 and M_4.

6.5 M_1, or money supply with the public, as defined by the Second Working Group, consists of currency notes and coins with the public, demand deposits of banks and salary earners' societies held by the public and 'other deposits' with the Reserve Bank. Thus only the most liquid and the most generally accepted means of payment available as a medium of exchange and for final settlement of claims are included in M_1, thus emphasizing the medium of exchange characteristic of money.

6.6 M_2 consists of savings deposits with the Post Office Savings Bank in addition to M_1. Broad money or M_3 includes time deposits (excluding inter-bank time deposits) of banks in addition to M_1. The broadest definition of money supply defined by the Second Working Group was M_4 which consists of M_3 and total deposits with the Post Office Savings Organisation (excluding National Savings Certificates). M_1 and M_3 were compiled and published on a weekly basis till end-March 1985 and thereafter they are published on a fortnightly basis, while M_2 and M_4 are made available on a monthly basis.

6.7 The treatment of savings deposits in the definition of money supply also merits some comment. These deposits stand in between current account deposits which earn no interest and fixed deposits which are eligible for interest. Savings deposits earn interest and at the same time are used as transactions balances. The bifurcation of these deposits into demand deposits and time deposits is, therefore, made on the basis of assumptions regarding the proportion of these deposits which could be considered to have the character of transactions balances. This proportion was worked out for the period 1961-75 by the Second Working Group on Money Supply

on the basis of applicability of withdrawal restrictions. It is found that the demand liability portion of these deposits, which corresponds to transactions balances, increased from 64.5 per cent in 1961 to 86.0 per cent in 1975 suggesting that savings deposits increasingly performed the function otherwise performed by currency. An alternative approach to the bifurcation of savings deposits was adopted in 1981 and data on money supply starting from the period March 1978 are now available on the basis of this new approach. The essence of this alternative method of bifurcating savings deposits into the demand liability and time liability portions lies in identifying a portion of these deposits on which interest is actually paid and treating this portion as time deposits, the balance being treated as demand deposits. This method of classification has resulted in a break in the M_1 series inasmuch as a sizeable portion of savings deposits was transferred from demand deposits to the category of time deposits. Apart from the statistical problem of loss of continuity in the M_1 series, this method of classification requires further examination in the light of the recent partial deregulation of interest rates payable on deposits of less than 1 year maturity. Banks are now free to offer upto 8 per cent per annum on short term deposits of less than 1 year maturity as compared to 5 per cent per annum which they offer on savings deposits pursuant to the RBI directives. The balances in savings deposit accounts could, in course of time primarily reflect the decision of the holders to hold them as transactions balances as interest conscious depositors shift that portion of the balances in the savings deposit accounts which is not held as transactions balances from savings deposits to fixed deposits of short term maturities. When that happens it might become necessary to include savings deposits *in toto* in demand liabilities portion while computing money supply series. However, world over the distinction between narrow money and broad money has become blurred with almost all types of deposits bearing interest.

6.8 Sources of Money Stock: Creation of money as defined earlier requires a simultaneous creation of credit. Therefore, changes in money stock can be studied through the 'balance sheet' or accounting approach by analysing the liabilities and assets of the banking sector defined to include the central bank and other banks, and the government's currency liabilities to the public.

6.9 The monetary liabilities of the banking sector in India consist of currency liabilities of the Reserve Bank, deposit liabilities of banks and 'other deposits' with the Reserve Bank. It should be noted that a part of currency with the public consists of rupee coins (and notes) and small coins which are the currency liabilities of the Government of India. These are not the liabilities of the Reserve Bank which only issues them to the public, on behalf of government, on demand, in exchange for other items of currency,

and accepts them back in exchange. The remaining, preponderant portion of currency with the public are the liabilities of the Reserve Bank. Further, the deposit liabilities of the banks included in money stock are only those that are liabilities to the public. Inter-bank deposits are not part of the money stock as these are part of inter-bank transactions which cancel out when the assets and liabilities of the banking system are consolidated. It may also be noted that deposit liabilities of the Reserve Bank to government are not included in liabilities forming part of money supply but are netted out against RBI credit to government.

6.10 The non-monetary liabilities of the banking sector (so called because they do not by definition form part of money supply) comprise certain deposits with the Reserve Bank such as Compulsory Deposit Scheme deposits, National Funds maintained by RBI, the IMF Account No. 1 with the Reserve Bank, banks' borrowings from abroad, capital and reserves of the Reserve Bank and banks, and other miscellaneous liabilities including profits of banks, and bills payable of the Reserve Bank, and profits of the Reserve Bank held for a brief period at the end of the accounting year. On the assets side, the financial assets of the banking sector comprise assets like loans and advances, investments in government and private securities and foreign exchange assets, while assets like buildings, sundry debtors etc. are classified as 'other assets'.

6.11 Net non-monetary liabilities are equal to the difference between non-monetary liabilities and 'other assets'. The financial assets of the banking sector less its net non-monetary liabilities, therefore, equal the total of the monetary liabilities of the banking sector and hence match the total money stock M_3.

6.12 Any change in the monetary liabilities of the banking sector *ceteris paribus* represents a change in money supply. A change in money supply can arise as a result of a change in government's currency liability but such changes are minimal in magnitude in comparison with changes in money supply due to changes in monetary liabilities of the banking system, and changes in monetary liabilities of the Reserve Bank.

6.13 **Reserve Money and the Money Multiplier** : Reserve money represents those liabilities of the central bank and the government that are deemed to be eligible as reserves to be held by banks for the purpose of deposit money creation in a system where the fractional reserve ratio governs the creation of deposit money. Generally, currency liabilities of the central bank and the government are considered as eligible for being held as bank reserves supporting deposit money creation. These liabilities are, therefore, the sum total of banks' reserves and currency with the

public. Banks' reserves consist of cash in hand with banks and bankers' deposits with RBI. Accordingly reserve money in India is the sum total of currency with the public as defined earlier and bankers' deposits with the Reserve Bank, cash with banks, and 'other deposits' with RBI which are liabilities of the Reserve Bank to the non-bank sector, and hence equivalent to currency with the public in so far as their relevance to deposit money creation of banks is concerned. In India reserve money consists predominantly of currency with the public.

6.14 Reserve money is also referred to in the literature on the subject as monetary base, high-powered money, base money, primary money or government money.

6.15 The ability of the banking system to create deposit money depends, on the amount of reserve money available and the portion of it which the public prefers to hold in the form of currency. In view of the public's preference for currency holding of a given amount, bank reserves take on a residual character. Public's preference for a given amount of currency holding is not constant but is influenced by a host of factors, such as payment habits in the economy, availability of banking services, statutory requirements in regard to mode of specific payments, desire for precautionary cash balances, apart from economic factors such as the rate of inflation, level of income and seasonal factors. The currency-deposit ratio is an indicator of the extent of public's preference for currency at any given point in time.

6.16 The ability of the banking system to create deposits also depends on the deposit multiplier which is computed on the basis of the reserves to be maintained by them as balances with the Reserve Bank pursuant to the cash reserve stipulations arising from the fractional reserve system of banking. The money multiplier relating reserve monev to money supply comprising currency and deposit money, therefore, is influenced both by the currency-deposit ratio and the deposit money multiplier.

6.17 The currency-deposit ratio in India has steadily fallen from 1.53 in March 1951 to 0.30 in March 1984, deposits in this computation representing aggregate deposits which are defined as demand deposits plus time deposits. This steep fall highlights the growth of deposits in the economy resulting from the rapid growth of banking facilities. The money multiplier has, therefore, risen from 1.54 in March 1951 to 2.98 in March 1984. In recent years the cash in hand with banks has stabilised at around 2 per cent of deposits or less. The growth in banks' balances with the Reserve Bank reflects the growth of deposits on the one hand and the impact of the cash reserve stipulations on the other. In view of this observed stability in the

level of cash in hand with banks, the changes in the deposit money multiplier are essentially brought about by changes in the cash reserve stipulations from time to time. These stipulations generally involve prescribing a required amount of reserves computed in relation to applicable demand and time liabilities of banks but also at times involve additionally prescribing an additional reserve requirement computed in relation to the level of demand and time liabilities, which accrued from a specified date. As of March 1984, the deposit money multiplier obtained as a ratio of deposit money to bank reserves was 7.68 as compared to 9.14 in March 1951. In practice the observed deposit multiplier is influenced not only by the required cash reserves and the irreducible level of cash in hand with banks but also by reserves in excess of the amount required for these purposes. Reserves held by banks in excess of the required minimum balances with the Reserve Bank, may be called excess reserves as they are not required for meeting cash reserve stipulations. These excess reserves could be either free reserves arising from the bank's normal operations, or may include reserves obtained by the banks from the Reserve Bank by way of refinance assistance. Excess reserves arising from the latter transactions are referred to as "borrowed reserves", and are an indication of the Reserve Bank's control over the banks' ability to utilise excess reserves for further deposit money creation. This control can be exercised by the Reserve Bank by seeking repayment of the refinance facilities to the extent desired or by refusing to renew the facilities. The Reserve Bank uses this lever as occasion demands to influence the banks' ability to make loans and hence generate deposits in the banking system.

6.18 Sources of Reserve Money: As mentioned earlier reserve money represents certain liabilities of the central bank and the currency liabilities of the government. These liabilities arise in the course of operations of these agencies and are matched by assets shown as sources of reserve money in published data. These assets are assets of the central bank, the currency liabilities of the government also appearing on the asset side as the Reserve Bank is the sole agency issuing rupee coins and small coins to the public on behalf of the government.

6.19 The need for providing increasing quantities of money in a growing economy to support a greater volume of transactions is satisfied by the Reserve Bank. It does so by obtaining claims on other sectors of the economy and providing its liabilities in exchange. The latter are converted by the recipients, if they are not banks, into currency holdings or deposits with the banks in order that they may use these resources for effecting payments. In either case the economy will have larger reserve money than before and depending on the operations of banks a larger money supply. In

case the Reserve Bank acquires claims against banks, in exchange for its liabilities which usually take the form of an increase in banks' balances with the Reserve Bank, banks would have acquired the power to create additional deposit money and are also likely to exercise this power without delay in order to compensate for the cost incurred by way of interest charges on the refinance facilities obtained from the Reserve Bank. The holding of excess reserves by a bank depends on a number of factors including fluctuations in economic activity, the general liquidity condition in the banking system, seasonal factors of particular relevance to its operations, and the penal provisions governing the maintenance of the cash reserve requirement.

6.20 In India, the main sources of reserve money as represented by the assets acquired by the Reserve Bank, and by the government's currency liabilities to the public which we have referred to earlier, are the following:

Reserve Money = Net RBI Credit to Government
+ RBI Credit to Banks
+ RBI Credit to Commercial Sector
+ Net Foreign Exchange Assets of RBI
+ Government's Currency Liabilities to the public
Less Net non-monetary liabilities of RBI

RBI credit to the Central Government and State Governments consists of RBI's holdings of Treasury Bills (including *ad hocs*), dated securities of the Central Government, and rupee coins, and RBI's advances to State Governments. RBI credit to government less government deposits with RBI is referred to as net RBI credit to government. RBI's credit to banks is the credit provided by it to commercial and co-operative banks * by way of accommodation provided against the security of government securities, usance bills, or promissiory notes and through the purchase or rediscounting of bills. Reserve Bank's credit to commercial sector is the aggregate of (a) Reserve Bank's investments in shares/bonds of financial institutions (b) Loans and advances to financial institutions such as IDBI, ARDC, and (c) Internal Bills purchased and discounted.

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* Since the resources which the co-operative banks and Regional Rural Banks mobilise from the savings of the community are inadequate to meet the rising and competing demand for credit from the different sectors of the rural economy, the Reserve Bank was providing financial accommodation to the State Co-operative Banks and Regional Rural Banks for agricultural as well as certain non-agricultural purposes. Such special support is no longer being extended to these banks since the inception of NABARD in July 1982. RBI claims in respect of such support prior to July 1982 have been taken over by NABARD as part of the overall scheme governing the establishment of NABARD as the apex bank in the field of agricultural and rural credit.

6.21 A look at the sources of reserve money in recent years will show that RBI's net credit to government was the principal source of reserve money. Net RBI credit to government as a proportion of reserve money was 83 per cent in 1970-71 and 85 per cent in 1980-81 and rose to 92 per cent in 1983-84.

6.22 Reserve Bank credit to commercial sector grew at an average annual rate of Rs. 117 crores during the Seventies against the average annual increase of Rs. 7 crores in the Sixties and less than one crore of rupees per year on the average in the Fifties. This higher volume of credit to commercial sector was mainly occasioned by the growth of development banks (IDBI, ARDC etc.). The net foreign exchange assets of RBI showed a notable increase only during the second half of the Seventies and exhibited considerable variability on an year to year basis. As against these changes, the average annual increase in net RBI credit to government rose successively from a level of Rs. 115 crores during the Fifties, to Rs. 183 crores in the Sixties and to Rs. 592 crores in the Seventies. Between March 1980 and March 1984 the increase in net RBI credit to government averaged Rs. 1,492 crores per annum.

6.23 A study on the behaviour of reserve money multiplier and money stock commissioned by the Committee shows that the multiplier can be predicted*. Another commissioned study on demand for currency and deposits also shows that demand for currency and deposits are stable and can be behaviourally explained**

6.24 A study of the relationship between reserve money and money stock must take into account the impact of changes in the Cash Reserve Ratio which directly affect the ratio of money stock to reserve money. Empirical studies of the multiplier accordingly must incorporate this impact explicitly by taking CRR as an additional variable or adjust the reserve base to a uniform Cash Reserve Ratio. The impact of changes in reserve requirements can thus be captured either in the money multiplier or in reserve money. The observed variability of the money multiplier may lead one to assert that the relationship between reserve money and money stock is strong. The money multiplier is, no doubt, affected by changes in the public's preference for currency but the variability of the observed multiplier is also due to statistical and other factors which must be isolated in order to understand the basic relationship. As already mentioned CRR changes must be taken into account by making suitable

* Vikas Chitre, "Quarterly Prediction of Reserve Money Multiplier and Money Stock in India" (Mimeograph).

** A.K. Lahiri, "Demand for Currency and Deposits" (Mimeograph).

adjustments in the level of reserve money. This would then reveal a relatively stable money multiplier as the public's preference for currency is found to change only gradually, thereby bringing out the relationship between reserve money and money stock into better focus. One would also expect such a relationship to be more clearly seen when the relevant magnitudes particularly that of reserve money are considered on an average basis. Since banks are to maintain their required reserves against net demand and time liabilities only as an average over a given period, it is necessary to take reserve money as average over the given period and not as on a given day of a week. Thus the observed relationships on a given date may not bring out the true relationship. Further, the relationship between reserve money and money stock need not necessarily be contemporaneous. It is in fact influenced by several factors resulting in a lagged relationship between changes in reserve money and changes in money stock. A suitable lagged structure must, therefore, be explicitly formulated in the empiricial study of the relationship. Yet another source of distortion in the observed statistical relationship arises from accounting compulsions faced by the government, and the banks at the time of closing of books at the end of their accounting years which happens to coincide with two calendar quarters viz. March and December respectively. Large changes in Reserve Bank credit to government occur as at the end of March, and deposit growth is sought to be maximised by banks just before they close their accounts in December. These accounting features of data introduce additional statistical noise. As against these adverse influences, one must note that the presence of a substantial volume of currency as a common component of reserve money and the money stock automatically increases the correlation between reserve money and money stock.

6.25 If due allowance is made for the influence of the above statistical factors, the relationship between reserve money and money stock in India can be described as quite strong in the Seventies on the basis of the findings of a recent study@. The implicit money multiplier derived on the basis of reserve money adjusted for changes in CRR over a base period showed far greater stability than that computed on the basis of an unadjusted reserve money. This stability and predictability of the money multiplier imparts greater strength to monetary regulation measures aimed at influencing the course of reserve money. It should, however, be noted that the stability of the money multiplier does not imply a corresponding stability of the deposit multiplier. Shifts between currency and deposits are often large, and they occur all the time and are prone to the influence of seasonal factors. The

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@ C. Rangarajan and Anoop Singh, "Reserve Money: Concepts and Policy Implications for India" (Reserve Bank of India Occasional Papers, June 1984).

incremental money multiplier relating M_1 and reserve money is, therefore prone to sudden and large movements particularly over short periods. The volatility is higher when the incremental multiplier is computed on the basis of data relating to specific points in time rather than on an average basis over a given period. The shifts from currency to deposits or from deposits to currency do not have the same influence over the money multiplier for M_3 which as a result is relatively more stable.

6.26 The sources of reserve money, and the factors influencing the behaviour of the money multiplier require, therefore, to be studied closely in order to explain changes in money supply. Looking at the sources of reserve money it is evident that such a study should necessarily cover an analysis of the wide range of developments influencing the sources of reserve money, and the behaviour of the money multiplier. Of these, the government's borrowing from the Reserve Bank is probably the most important in the Indian context and hence is discussed at some length in Chapter 9.

Chapter 7 : OUTPUT AND PRICES

Before we undertake a review of the recent monetary policy measures in the next chapter, we would like to present briefly the trends in output and prices and comment on certain aspects of the behaviour of output and prices in the Indian economy which are of particular relevance to the conduct of monetary policy, and to the functioning of the monetary system in general.

7.2 In India, the agricultural sector continues to have an important place in the economy although its share in gross domestic product has declined over the years. The performance of the agricultural sector has a pervasive influence on the growth of the economy as a whole and particularly on industrial production and the price situation. While the dependence of certain industries on supplies of agricultural raw materials is well known, the demand emanating from the agricultural sector has also been found to be of particular importance to a wide spectrum of industries.

7.3 There has been a definite shift in the pattern of distribution of the GDP among different sectors. The contribution of agriculture and allied activities to GDP has steadily declined from 48.5 per cent in 1970-71 to 39.4 per cent in 1983-84. Manufacturing, construction, electricity, gas and water supply constituted 20 per cent of GDP in 1970-71 and their share has since increased only slightly over that level. The tertiary sector's contribution has been steadily increasing over the years, its contribution having risen from 30.8 per cent in 1970-71 to 38.2 per cent in 1983-84.

7.4 Annual growth rates of GDP varied between 9.5 per cent and–5.0 per cent during 1971-72–1983-84. Agricultural production which increased at an average of 3.4 per cent per annum during 1971-72–1983-84 has also shown wide fluctuations from year to year as can be seen from Table 1. Similarly, there have been wide year to year fluctuations in the output of non-food agricultural commodities. Fluctuations in agricultural production have had their impact on the growth of manufacturing output in which agro-based industries have a share of about 33 per cent. The index of industrial production during 1970-71–1983-84 rose at an average annual rate of 4.7 per cent, growth rates in individual years ranging from 9.5 per cent to –1.9 per cent.

7.5 The data relating to capacity utilisation in selected industries have

Table 1 : Annual Changes in Gross Domestic Product, Agricultural Production and Industrial Production

(per cent)

Year ending June	Gross Domestic Product@	Agricultural Production*	Foodgrains Production*	Non-Foodgrains Production*	Industrial Production**
1971-72	−1.6	− 0.3	− 1.3	2.1	5.9
1972-73	− 1.1	− 8.0	− 8.2	− 7.8	2.7
1973-74	4.7	9.9	7.8	14.5	3.0
1974-75	1.1	− 3.2	− 5.4	1.1	1.8
1975-76	9.5	15.0	22.0	1.7	9.5
1976-77	0.9	− 6.8	− 9.0	− 2.3	7.7
1977-78	8.7	14.2	15.5	12.3	4.3
1978-79	5.8	3.9	4.3	2.4	5.6
1979-80	−5.0	−15.2	−17.6	− 9.9	−1.9
1980-81	7.6	15.7	19.8	7.1	7.3
1981-82	4.8	5.5	2.2	13.2	7.3
1982-83+	2.1	− 4.0	− 4.2	− 3.7	3.3
1983-84+	7.4	13.7	18.9	3.3	6.2

@ Gross Domestic Product at factor cost at 1970-71 prices (year ending March)

* Index number of agricultural production (Triennium ending 1969-70 = 100)

** Computed on July-June basis (Base 1970 = 100)

+*Provisional*

Sources : **Report on Currency and Finance (Reserve Bank of India).**
Economic Survey (Government of India).
National Accounts Statistics (Central Statistical Organisation, Government of India).

been presented in Table 2. Constraints in agricultural growth, shortage of raw materials, and infrastructural problems relating to availability of transport, power and fuel, and inadequate demand have all contributed to the considerable under-utilisation of capacity in the manufacturing sector over the years. Basic industries and capital goods industries on an average performed at considerably lower capacity utilisation levels than intermediate goods and consumer goods industries.

7.6 Table 3 presents the annual variation in the wholesale price index, for all commodities and the three main groups, viz, primary articles, fuel, power, light and lubricants; and manufactured products.

7.7 During the period 1970-71–1983-84 there was a decline in prices, of only a small order, in just one year, viz., 1975-76. The two years pre-

Table 2: Average Capacity Utilisation in Major Industry Groups (1970-1982)

(per cent)

Year ending December	Major Industries (50.75)	Basic Industries (16.98)	Capital Goods Industries (6.69)	Intermediate Goods Industries (11.67)	Consumer Goods Industries (15.41)
1970	75.5	55.0	79.1	82.6	91.1
1971	76.3	55.8	80.0	87.8	88.8
1972	74.5	58.1	80.6	84.6	82.4
1973	71.8	55.6	74.0	80.9	81.7
1974	69.3	55.6	63.9	77.1	80.8
1975	68.0	60.3	56.8	73.5	77.1
1976	70.7	68.2	57.2	73.7	77.2
1977	70.8	62.5	59.8	77.9	79.5
1978	74.0	62.6	60.9	83.6	85.1
1979	71.4	56.8	62.3	83.8	81.4
1980	70.0	58.5	61.7	84.8	75.1
1981	74.5	62.6	71.7	87.2	79.2
1982	69.8	56.7	66.7	79.5	78.2

Note: Capacity utilisation is defined as the ratio of production to installed capacity of an industry.

Source: IDBI annual report 1982-83.

Figures within brackets represent weights of industries selected under each industry group.

ceding this had witnessed an inflation rate of 20.2 per cent and 25.2 per cent. The years 1979-80 and 1980-81 were again years of high inflation, the rate of increase in the wholesale price index being 17.1 and 18.2 per cent respectively. Again in 1983-84 the rate of increase in price of 9.25 per cent could be considered to be relatively high taking into account the bumper food crop in that year as also the high rate of growth in output.

7.8 The rise in prices in the case of primary articles was 204 per cent over the base year 1970-71 i.e. an average increase of 9.3 per cent per

Table 3: Annual Changes in the Wholesale Price Index*

(per cent)

Year ending March	All Commodities (100.0)	Primary Articles (41.67)	Fuel, Power, Light and Lubricants (8.46)	Manufactured Products (49.87)
1972	5.60	0.90	5.90	9.50
1973	10.04	9.71	3.97	11.32
1974	20.22	28.09	18.62	14.44
1975	25.20	25.18	51.84	21.00
1976	−1.09	−6.59	10.54	1.42
1977	2.08	0.84	5.29	2.33
1978	5.21	9.93	1.47	2.28
1979	0.00	−1.31	4.48	0.17
1980	17.12	13.84	15.69	20.22
1981	18.24	15.01	25.15	19.23
1982	9.33	11.33	20.66	5.17
1983	2.60	3.59	7.30	0.55
1984 (Provisional)	9.25	10.99	6.82	8.45
Average Annual change during 1971-72–1983-84	9.5	9.3	13.7	8.9

* Base: 1970-71 = 100.
Figures in brackets indicate weights.
Source: H.L. Chandok, Wholesale Prices in India; (Economic and Scientific Research Foundation, New Delhi). Report on Currency and Finance, (Reserve Bank of India).

annum. During this period, the annual increase in prices of primary articles exceeded 25 per cent in two consecutive years in the mid-Seventies.

7.9 The prices of fuel, power, light and lubricants rose by 390 per cent between the base year 1970-71 and 1983-84 i.e. at an average annual rate of 13.7 per cent.

7.10 The increase in the prices of manufactured products between 1970-71 and 1983-84 was the least, their prices increasing at the rate of 8.9 per cent per annum. In terms of year to year changes, movements in the prices of manufactured products were similar to those of the other two groups.

7.11 Supply factors, particularly fluctuations in output in the agricultural sector as well as cost push factors and monetary expansion have contributed to inflation. If the structure of inflation is examined then it is seen that food prices have a considerable impact on the rate of inflation.

7.12 Annual variations in the different consumer price indices are presented in Table 4.

Table 4: Annual Changes in the Consumer Price Index

(per cent)

Year ending March	Industrial Workers *	Urban Non-manual Employees *	Agricultural Labourers @
1972	3.22	3.45	4.17
1973	7.81	6.67	12.50
1974	20.77	15.10	25.78
1975	26.80	22.17	30.04
1976	−1.26	2.59	−13.86
1977	−3.83	0.00	−14.73
1978	7.64	6.86	6.95
1979	2.16	3.38	−1.86
1980	8.76	7.84	13.86
1981	11.39	11.82	13.61
1982	12.47	11.92	9.54
1983	7.76	7.99	7.37
1984 (Provisional)	12.55	10.31	8.52

* Base 1960 = 100

@ Base: July 1960—June 1961 = 100

Source: Report on Currency and Finance (Reserve Bank of India).

7.13 The consumer price index for industrial workers stood at 547 points in 1983-84 having increased since 1970-71, at an average annual rate of 8.9 per cent per annum. Like wholesale prices, the consumer prices also showed an increase of more than 20 per cent during 1973-74 and 1974-75. The index declined only during the two years 1975-76 and 1976-77 by 1.3 per cent and 3.8 per cent respectively.

7.14 The consumer price index of urban non-manual employees increased at the rate of 8.5 per cent per annum from 174 in 1970-71 to 492 in

1983-84 and exhibited a continuous upward trend except during 1977 when there was no change in the index at 277.

7.15 The trend in the movement of the consumer price index for agricultural labourers was broadly similar to that of the index for industrial workers.

7.16 The rate of change in the price level as measured by annual changes in the wholesale price index during 1961-62 — 1970-71 was moderate at 6.2 per cent, and during 1971-72 — 1983-84 it was markedly higher at 9.5 per cent per annum (Table 5). The latter period has witnessed four years of severe inflation, partly accounted for by crop failures and the impact of increases in world oil prices.

Table 5: Average Annual Changes in the Price Level*

(per cent)

	All Commodities (100.00)	Primary Articles (41.67)	Fuel, Power Light & Lubricants (8.46)	Manufactured Products (49.87)
1951-52 — 1960-61	1.8	1.0	3.0	2.4
1961-62 — 1970-71	6.2	7.5	8.1	5.4
1971-72 — 1980-81	10.3	9.5	14.3	10.2
1971-72 — 1983-84	9.5	9.3	13.7	8.9

* Wholesale price index (Base: 1970-71 = 100).
Figures in brackets indicate weights in the index.

Inflation Rate in India and OECD Countries

7.17 The inflation rates in India and OECD countries are presented in Table 6 for the recent decades. It can be seen that during the Fifties, the inflation rate in India as compared to the OECD countries was not very much higher. Japan had a higher rate of inflation than India. During the Sixties except for Iceland all the other countries had a lower inflation rate compared to India's 6.1 per cent. During the Seventies we find that a majority of the OECD countries experienced a sharper increase in the price

Table 6: Change in Price Level in India and in OECD Countries

(per cent per annum)

	1952-59	1960-69	1970-79	1970-83	1980-83
India	1.9	6.1	7.4	8.5	11.0
OECD Countries					
United States	1.4*	2.3*	7.1*	7.4*	8.3*
Japan	2.9	5.5*	9.0	7.7*	4.4*
West Germany	1.2*	2.4*	5.0*	4.9*	4.9*
France	4.5	3.9*	8.9	9.8	12.1
United Kingdom	3.0	3.4*	12.7	12.1	9.8*
Italy	1.9	3.7*	12.3	13.8	17.5
Canada	1.4*	2.5*	7.4	8.1*	9.8*
Austria	3.1	3.3*	6.1*	5.9*	5.5*
Belgium	1.2*	2.7*	7.1*	7.3*	9.0*
Denmark	2.7	5.4*	9.3	9.6	10.3*
Finland	3.9	4.9*	10.5	10.4	10.4*
Greece	5.7	1.9*	12.3	15.3	22.7
Iceland	5.9	10.8	29.5	38.6	61.1
Ireland	3.7	4.0*	14.2	14.9	16.6
Luxembourg	1.1*	2.2*	6.5*	7.0*	8.1*
Netherlands	2.1	4.0*	7.0*	6.6*	5.5*
Norway	2.8	3.5*	7.6	8.6	11.1
Portugal	1.1*	4.2*	17.4	18.5	21.1
Spain	5.3	5.8*	14.5	14.4	14.2
Sweden	3.6	3.7*	8.7	9.3	10.8*
Switzerland	1.0*	3.1*	5.0*	4.9*	4.8*
Turkey	11.6	5.8*	27.1	33.2	48.3
Australia	4.5	2.4*	9.8	10.0	10.3*
New Zealand	4.2	3.2*	11.4	12.2	14.0

Percentage change in consumer price index (Base: 1970 = 100, calendar year basis).

* Indicates lower rate of inflation as compared to India.

Source: International Financial Statistics.

level than the 7.4 per cent rate of inflation in India. Germany and Switzerland, however, had a lower inflation rate of only 5.0 per cent followed by Austria (6.1 per cent) and Luxembourg (6.5 per cent). U.S.A. had an inflation rate of 7.1 per cent.

7.18 During 1970-79 only seven out of the twenty four OECD countries had an inflation rate lower than the 7.4 per cent inflation rate in India. During the period 1970-83 the consumer price index rose at an average annual rate of 4.9 per cent in West Germany, 7.4 per cent in U.S.A. and 7.7 per cent in Japan, as compared to the higher average rate of increase in the consumer price index of 8.5 per cent in India. The average annual rate of inflation measured in terms of the consumer price index was 11 per cent in India during the four year period 1980-83. Out of the twenty four OECD countries, fourteen countries had inflation rates lower than India during this period; the rate of inflation was much lower at only 4.4 per cent in Japan and 4.9 per cent in West Germany while the price level in U.S.A. rose by 8.3 per cent during this period.

7.19 The maintenance of reasonable price stability depends upon the management of aggregate demand and supply through timely and appropriate policies. We propose to review, in the next chapter, the role of monetary policy measures since 1970 in aggregate demand management.

Chapter 8 : REVIEW OF MONETARY POLICY MEASURES SINCE 1970

In the previous chapters we have reviewed in some detail the major developments in the Indian economy which have a bearing on the functioning of the monetary system. On the basis of this review we now proceed to examine the conduct of monetary policy during the last fifteen years with a view to assess its effectiveness in different economic situations which prevailed during the period being reviewed.

8.2 At the outset, it would be useful to note that between 1970-71 and 1983-84 net national product rose by 58.5 per cent and the wholesale price index rose by 215.3 per cent, while M_3 increased by as much as 683.9 per cent between March 1971 and March 1984. While output growth exhibited considerable variability from year to year due mainly to weather induced fluctuations in agricultural output, the trend in prices was generally upward though the annual changes in prices also exhibited large variations. The expansion in M_3, however, was steep particularly in the latter half of the Seventies. In certain years during the last decade and a half the external sector had a noticeable impact on the domestic economic scene, the oil shock of 1973 and 1979-80 being the important developments in the external sector during this period, apart from a notable increase in remittances from abroad by non-resident Indians from the mid-Seventies in response to certain interest rate incentives under special deposit schemes.

8.3 The tasks faced by the monetary authorities in the light of developments mentioned here were primarily related to aggregate demand management with a focus on arresting steep increases in the price level which were expected to occur in the wake of periodical setbacks to agricultural output, particularly foodgrains output, and as a result of external factors.

8.4 The important tools of monetary policy which were available to the monetary authority to perform its tasks were interest rate policy, refinance policy, variations in cash reserve requirements, quantitative control of bank credit and moral suasion. Open market operations did not have much scope as the market in government securities was narrow and the demand for such securities arose mainly out of statutory requirements in the absence of attractive coupon rates on these securities. Selective credit controls applied to certain specified commodities and did not cover the bulk of bank credit. In the absence of a broad-based money market, the Bank Rate had a limited role.

8.5 Interest rate policy lost its edge when the discount rate on Treasury Bills ceased to be changed since 1974, and yields on government securities were maintained at relatively low levels through the mechanism of the Statutory Liquidity Ratio and its frequent upward revision. Though upward revisions in the yields on government securities have been effected over the recent years, these revisions were of minor significance as real yields were often negative. Further, they also did not result in increasing the scope for open market operations. Nonetheless, interest rate policy was on occasions successfully used during the period being reviewed as a means of influencing demand for bank credit from the non-government sector notably in 1974 when the Bank Rate was raised sharply and again in 1979-80 when the increase in the maximum bank lending rate was an unprecedented 3 percentage points.

8.6 The refinance policy was mainly oriented towards assisting banks to channel credit to certain preferred sectors, and therefore refinance to banks had limitations as a monetary control measure. The flexible part of refinance policy related to stand-by refinance and discretionary refinance but these facilities have evidently dwindled in magnitude as a result of continued monetary restraint and hence lost their importance as a tool of monetary control.

8.7 The single, most important factor influencing the conduct of monetary policy since 1970 is the phenomenal increase in reserve money. The major component of this increase was the increase in Reserve Bank credit to government on which the central bank had little control (Table 1).

Table 1 : Increase in Reserve Money (1970-1985)

(Rupees Crores)

	Total Increase in Reserve Money	Increase in Reserve Bank credit to Government	Increase in Net Foreign Exchange Assets of RBI	Other items
March 1970 to March 1975	2997	3074	-183	106
March 1975 to March 1980	9077	5835	4997	-1755
March 1980 to March 1985	15020	17369	-2344	-5

8.8 The steep rise in the level of reserve money gave a strong impetus to monetary expansion, and the expansionary impact of reserve money increased over the years as the average money multiplier rose reflecting the gradual decline of the currency-deposit ratio in the wake of a substantial geographical expansion of the branch net-work of banks since 1970. The deflationary impact of a fall in the net foreign exchange assets of the Reserve Bank whenever it occurred was generally neutralised by the rise in Reserve Bank credit to government. As mentioned earlier the Reserve Bank had little flexibility in influencing reserve money growth through cutting down on its refinance to banks, both because of its preferred-sector orientation and its otherwise relatively small magnitude.

8.9 In view of the above, the only feasible approach to the control of monetary expansion was to influence the value of the money multiplier by raising the Cash Reserve Ratio. This was done repeatedly and the rise in the average money multiplier was more or less arrested after the mid-Seventies and stabilised at a level slightly below 3.0. This achievement fell far short of the requirements of the situation in several years during the period under review when a drastic reduction in the rate of growth of M_3 was called for.

8.10 The considerable variations from year to year of the incremental money multiplier (as observed from the year end data) gave rise to a view that as the timing of the increase in reserve money and that in money supply did not often coincide, even allowing for some lag, the former could not be considered as the root cause of inflationary pressures witnessed in the economy. The factors influencing price behaviour were no doubt complex but there can be no doubt that monetary expansion of a substantial order emanating from current and lagged effects of increases in reserve money was an important factor leading to inflationary pressures.

8.11 As fiscal deficits were generally accommodated by the central bank, monetary policy had, no doubt, a difficult role to perform. However, during the period under review, at times when drastic monetary control measures were the need of the hour the Reserve Bank and the government have closely co-ordinated their actions and have thereby achieved the desired results. Instances of such co-ordination have demonstrated the powerful impact of such concerted action by the Reserve Bank and the government and serve to stress the importance of close consultations between them in order to develop common perceptions of the emerging trends in the economy and the desirable lines of policy action.

8.12 Having provided a backdrop in the foregoing paragraphs for a review of specific monetary policy measures, we now discuss in some detail monetary policy in action during specific years over the last decade and a half. Our discussion will mainly focus on the recognition lag and the

implementation lag in monetary policy, and given its limitations as highlighted earlier, not so much on the final outcome of monetary policy actions.*

1970-71

8.13 The increase in output of 5.6 per cent in 1970-71 followed the growth in output of 6.2 per cent in the previous year, bringing down the rate of increase in the price level from 6.7 per cent to 3.3 per cent, although M_3 increased at the annual rate of 17.6 per cent in the second half of 1969-70 and at 16.5 per cent in 1970-71. In order to bring down the rate of expansion in bank credit which had reached an annual rate of increase of 32 per cent in the second half of 1969-70, the Net Liquidity Ratio was raised from 31 per cent to 32 per cent in April 1970, and further to 33 per cent in August 1970 and 34 per cent in January 1971. These increases in NLR, and the raising of Statutory Liquidity Ratio from 26 per cent to 28 per cent in two stages during April-August 1970, contained the rise in bank credit to 18 per cent in 1970-71 as compared to 16.9 per cent in 1969-70 and helped prevent a further expansion in M_3 in 1970-71 beyond the annualised rate of increase of 17.6 per cent in the latter half of 1969-70. Although these measures did not have an immediate impact on the expansion in M_3 during the first half of 1970-71 they resulted in restraining the expansion of M_3 in the second half of 1970-71 which also witnessed a fall in the price level of the order of less than one per cent.

1971-72 and 1972-73

8.14 The rise in output in 1971-72 was nominal and was followed by a fall of 1.4 per cent in the next year. As a result of this poor performance on the production front, the increase in the price level between March 1971 and March 1972 was 7.8 per cent and still higher at 12.8 per cent over the next twelve months. The increase in prices was much sharper during the first half of the two years as compared to the increase in prices in the second half while the opposite was true in the case of expansion in M_3. The expansion in M_3 at an annual rate of 20.1 per cent during the second half of 1971-72 reflected the impact of a steep rise in Reserve Bank credit to government in the wake of unforeseen expenditures connected with evacuee relief operations and defence expenditure, although the SLR was raised to 29 per cent in August 1972 and to 30 per cent in November 1972. Its impact on prices could be seen during the first half 1972-73, prompting an increase in NLR by 2 percentage points in November 1972 and a further increase by one percentage point to 37 per cent by March 1973.

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* Relevant data on monetary aggregates are presented in Table 2 and Table 3 at the end of this chapter.

This did not have the desired impact on M_3 which grew at a yet faster annual rate of 25.5 per cent during the second half of 1972-73 as compared to the corresponding period in the previous year. As no other effective monetary control measure was taken in 1971-73 despite low growth in output, the increase in prices in 1972-73 was of the order of 12.8 per cent, and the overall price increase between March 1971 and March 1973 was as high as 21.5 per cent, with M_3 increasing by 37 per cent over these two years and setting the stage for a steep rise in prices in 1973-74.

1973-74

8.15 The build up of inflationary pressures over 1971-73 seems to have been recognised by the central bank only in May 1973 as evidenced by the timing of corrective monetary policy action which consisted of an increase in the Bank Rate from 6 per cent to 7 per cent and in penal rates on borrowings from RBI, coupled with a 2 percentage point increase in CRR from 3 per cent to 5 per cent in May 1973. Despite these measures the rise in M_3 was at the annualised rate of 16.6 per cent during the first half of 1973-74 as compared to an annualised rate of increase of 10.5 per cent in the corresponding period of the previous year. Evidently the monetary control measures did not prove strong enough and the central bank went in for further increase in CRR from 5 per cent to 7 per cent in September 1973 together with a rise in NLR by one percentage point which had a noticeable impact on the rate of monetary expansion in the second half of 1973-74 and helped in restricting the monetary expansion in 1973-74 to 16.9 per cent, a level slightly lower than in the previous year. Weak and delayed monetary control measures in the first half of 1973-74 allowed prices to rise at an annualised rate of 24 per cent. The acute shortage of supplies following two successive years of virtually no growth in output was to be expected in the months prior to the kharif crop of 1973 and hence the expansion of bank credit in the second half of 1972-73 by as much as 34.2 per cent on an annualised basis should have been considerably curtailed in order to gain more manoeuvrability in 1973-74. That the central bank could have put such greater manoeuvrability to good use was evident in October 1973 with the oil shock. The minimum lending rate of commercial banks stipulated at 10 per cent in June 1973 and raised to 11 per cent in December, as also the quantitative credit ceilings–imposed for the first time–for the busy season (October – April) did not restrain the growth rate of bank credit in the second half of 1973-74, the rise in bank credit being at the same high rate of 34 per cent on an annualised basis as in the corresponding period of 1972-73. This was not probably a mean achievement considering the impact of the 1973 oil shock and the higher financing needs associated with the growth in output of 5.2 per cent in 1973-74. Nevertheless, the increase in bank credit of the order witnessed

in the second half of 1973-74 was not justified by the increase in industrial production which averaged only 2.0 per cent for the year as compared to 4.0 per cent in the previous year. Increase in refinance facilities diluted the impact of cash reserve requirements which were, as mentioned earlier, imposed in a halting manner and not early enough. Monetary policy measures failed to check the rise in prices which increased at the annualised rate of 30.8 per cent between September 1973 and March 1974, following a 24 per cent rise in the first half of the year and resulted in an annual increase in the price level of as much as 29 per cent and contributed to strong inflationary expectations. The build up of inflationary pressures in 1971-73 and the delayed and perhaps inadequate response of the central bank to the emerging inflationary situation probably contributed to a greater extent than the 1973 oil shock to the steep rise in prices in 1973-74.

1974-75

8.16 The impact of the expansion in reserve money of Rs. 1,245 crores in 1973-74, which exceeded the expansion in the previous two years, on prices continued to be felt in the first half of 1974-75. The Railway strike in May probably prompted anticipatory stockpiling by industry and trade and gave substantial support to inflationary expectations. The monetary regulation measures taken in late 1973 such as raising of the minimum lending rate to 11 per cent in December 1973 and raising of the CRR to 7 per cent in September 1973proved ineffective in controlling inflation and inexplicably were not followed up with any further restrictive measures till July 1974, and on the contrary, a reduction in CRR to 5 per cent was effected in June 1974. Considering that the wholesale price index rose from 157.5 in March 1974 to 182.0 in September 1974 representing an annualised rate of 31.1 per cent, the absence of additional monetary control measures during the first six months of 1974 is difficult to comprehend unless it is attributed to the need to provide liberal credit facilities to industry and trade for protective stockpiling prior to the Railway strike.

8.17 Strong measures to control inflation were eventually taken in July 1974 by the government which took steps to curtail expenditure, and introduced comprehensive measures to curtail disposable incomes such as impounding of additional dearness allowance, restriction on dividend payments, compulsory savings scheme for income tax payers in the higher income brackets. These measures which reduced aggregate demand also had a notable impact on expectations, which was reinforced by an unprecedented 2 percentage point rise in the Bank Rate in July 1974 from 7 per cent to 9 per cent during what is generally the slack season for banks.

These measures had an early impact and brought down the rate of monetary expansion in the first half of 1974-75 to an annualised rate of 10.0 per cent which was substantially lower than the expansion of 16.6 per cent on an annualised basis in the first half of 1973-74, and 15.9 per cent in the second half of 1973-74. The rate of monetary expansion in the second half of 1974-75 was only slightly higher at 10.9 per cent on an annualised basis, the overall increase in 1974-75 being restricted to 10.7 per cent as against 16.9 per cent over the previous year. The severe curtailment in the rates of monetary expansion and the dampening of inflationary expectations led to a 8.2 per cent decline in the wholesale price index in the second half of 1974-75 despite a poor performance on the output front. The net national product increased by only 1.5 per cent reflecting mainly a 5.4 per cent fall in food production, with total agricultural production declining by 3.2 per cent, and industrial production registering a rise of only 2.5 per cent.

8.18 Monetary control measures were eased in December 1974 when CRR was reduced from 4.5 per cent to 4 per cent, and the Net Liquidity Ratio was lowered to 39.0 per cent. Non-food bank credit during the second half of 1974-75 was thus permitted to rise by 21.7 per cent on an annualised basis as compared to the steep rise of 32.8 per cent in the second-half of the previous year, despite low growth in output referred to earlier. Inflationary pressures were brought very much under control by the end of 1974-75, as a result primarily of fiscal measures which restricted expansion in reserve money and in M_3. The substantial expansion of bank credit during the second half of 1973-74 and 1974-75 showed that in periods of inflation the lending rates of banks did not have much of an impact on demand for bank credit and hence the CRR weapon should have been used with greater force than was actually the case.

1975-76

8.19 The rise in wholesale prices during the first half of 1975-76 was nominal with bank credit expanding at only 6.8 per cent on an annualised basis, after the poor kharif crop in 1974. The expansion in M_3 during the first half of 1975-76 was maintained considerably below the rate of expansion of 10.0 per cent on an annualised basis during the corresponding period of 1974-75 which followed a marked rise in agricultural production in 1973-74. The second half of 1975-76 was marked by a record agricultural output. There was an increase of 9.8 per cent in the net national product in 1975-76 with a revival also in industrial production. The strong anti-inflationary impact of the rise in output of this order was seen in the decline in the wholesale price index by 16.8 per cent on an annualised basis during the second half of 1975-76. In response to the growth in output, bank credit and M_3 were permitted to rise during the second half

of 1975-76 at a much faster rate than during the corresponding period of the previous year. The decline in the wholesale price index between March 1975 and March 1976 was of the order of 6.9 per cent reflecting the impact of the continued operation of the anti-inflationary fiscal measures implemented in July 1974 and the vastly improved agricultural and other supplies. Although inflationary pressures were subdued and a reversal in the rising trend of prices was witnessed in the second half of 1975-76, it is difficult to justify the increase in non-food bank credit by as much as 22.7 per cent on an annualised basis, which in real terms was of the order of 43.1 per cent on an annualised basis. In absolute terms, non-food bank credit rose by Rs. 797 crores between September 1974 and March 1975, whereas between September 1975 and March 1976 it increased by Rs. 953 crores. The withdrawal of the Net Liquidity Ratio stipulation in November 1975 introduced an element of liberalisation in credit policy during the second half of the year which might partly explain this rise in non-food bank credit.

1976-77

8.20 The rise in prices during the first half of 1976-77 by as much as 20.8 per cent on an annualised basis, despite the high rate of growth of output in 1975-76 pointed to the need for continued caution which ought to have characterised the monetary policy stance during the period. M_3 rose by 23.0 per cent on an annualised basis during the first half of 1976-77 as against 5.6 per cent during the corresponding period of the previous year and even exceeded the high growth rates in M_3 witnessed during the first half of 1970-71 and 1973-74. Similar was the case with bank credit, increase in food credit being the main contributory factor. With the formal transfer of the responsibility for financing procurement operations in food from the government to the banking system in 1975-76, food credit rose from a level of Rs. 655 crores in September 1975 to as much as Rs. 1,521 crores in March 1976, and further to Rs. 2,110 crores in September 1976. Accordingly total bank credit during the first half of 1976-77 rose by 18.2 per cent on an annualised basis The expansion during the period in non-food credit was Rs. 400 crores or 8.6 per cent on an annualised basis in line with the moderate rise normally witnessed during the period March-September.

8.21 Another new expansionary factor, other than the newly acquired responsibility of the banking system to finance food procurement operations, was the expansion in net foreign exchange assets of the Reserve Bank as a result of the large inflow of remittances from abroad. These assets rose by Rs. 533 crores in 1975-76 and again by Rs. 1,675 crores in 1976-77. While the increase in reserve money was contained at a level of Rs. 344 crores in 1975-76 following an increase of only Rs. 128

crores in the previous year, there was a sharp increase in reserve money in 1976-77 to the extent of an unprecedented Rs. 1,812 crores. Increase in net foreign exchange assets of the Reserve Bank was the major contributor to this increase, but the increase in Reserve Bank credit to government of Rs. 838 crores, and increase in refinance to banks of Rs. 967 crores also contributed to the sharp rise in reserve money. The rise in M_3 of more than Rs. 2565 crores during March-September 1976 as compared to a rise of only Rs. 546 crores during the first half of 1975-76 should have sounded a warning signal to the central bank, which had already relaxed monetary restraint measures towards the end of 1974 by lowering CRR and NLR levels, and had discovered that the credit-deposit ratio of 76.8 per cent in March 1976 had exceeded its target of 71-72 per cent. In March 1976 the bank fixed a ceiling of 16.50 per cent on the lending rate of the larger scheduled commercial banks while earlier it had only stipulated a minimum lending rate. No new monetary control measure was announced during the first half of 1976-77 which witnessed a sharp rise in prices, M_3 levels and in the credit-deposit ratio.

8.22 It was only in September 1976, that some monetary control action was again in evidence with CRR being raised from 4 per cent to 5 per cent. The inadequacy of the measure was realised soon enough and the CRR was raised to 6 per cent in November 1976. The expansionary factors, to which we have already referred, required an yet stronger measure of control which came in January 1977 in the form of an additional cash reserve requirement of 10 per cent on the incremental net demand and time liabilities accruing since January 14, 1977. This was a strong measure of monetary control which was not withdrawn for a few years. As a result of these measures bank reserves which stood at Rs. 865 crores in September 1976 rose to Rs. 1,176 crores in March 1977 and expansion in bank credit was limited to 22.0 per cent as against 40.2 per cent in the second half of 1975-76. The lower expansion in bank credit was justified by the low growth in output of 0.5 per cent in 1976-77. Over the year as a whole, prices rose by 12.5 per cent, M_3 by 22.4 per cent and bank credit by 21.1 per cent. Had timely monetary control measures been forthcoming in the first half of 1976-77 the rise in prices could probably have been moderated.

1977-78

8.23 The first half of 1977-78 witnessed a marginal decline in reserve money, and a sizeable fall in refinance levels from Rs. 967 crores in March 1977 to Rs. 319 crores in September 1977. Bank credit rose by 6.8 per cent on an annualised basis and the price rise was moderate at 5.8 per cent on an annualised basis. Inflationary pressures appeared to have waned although the rise in M_3 at an annualised rate of 17.0 per cent should have

caused some anxiety to the central bank till prospects of a record kharif output in 1977 became a certainty.

8.24 In May 1977, the Reserve Bank discontinued the practice of prescribing a quota for rediscounting of inland bills purchased/discounted by banks up to 10 per cent of such bills against which the banks were able to obtain refinance and decided to offer rediscounting facilities only on a discretionary basis subject to such terms and conditions as may be stipulated by it. The basic refinance quota to enable banks to meet clearing imbalances and similar operational requirements was not changed and continued at 1 per cent of demand and time liabilities but this was not in much use and was replaced in June 1978 by refinance under standby arrangements at the Bank Rate which could be availed of by banks as an exception rather than as a rule. These developments in regard to the refinance facilities virtually brought to an end their role as an additional monetary control measure in subsequent periods. The second half of 1977-78 started with a notable increase in the kharif crop which enabled the net national product to register a significant increase of 9.1 per cent in 1977-78. The impact of the increase in output of this order was felt on the price level, as in 1975-76. The price situation was again very much under control and the rise in M_3 over the year of 20.6 per cent, and the increase in bank credit of 13.4 per cent were held below the previous year's level. Expectedly non-food bank credit increased at a higher annualised rate of 29.2 per cent during the second half of 1977-78 as compared to an annualised rate of 25.2 per cent during the corresponding period of the previous year. Food credit in the second half of 1977-78 fell sharply and contributed to the lower overall expansion in bank credit during 1977-78. The credit-deposit ratio declined from 75 per cent in March 1977 to 69.2 per cent in September 1977 and further to 67.3 per cent in March 1978.

8.25 The additional cash reserve requirements continued but banks got some relief by way of an increase in the interest payable on the additional reserves from 5.5 per cent to 6.0 per cent. In March 1978 lending rates were reduced and the maximum lending rate of 16.5 per cent was brought down to 15 per cent with the abolition of the interest tax.

8.26 Deposits rose sharply between March 1976 and March 1977 and even faster at 26.4 per cent between March 1977 and March 1978, partly as a consequence of remittances from abroad and plausibly due to an attractive real rate of return. A downward revision of deposit rates was effected in June 1977 for maturities less than five years, and in March 1978 deposits with a maturity of five years or more were also covered. During the last fifteen years these reductions in interest rates represented a solitary instance of a downward revision in interest rates on term deposits.

1978-79

8.27 On the basis of weekly averages, the wholesale price index in 1978-79 stood at the same level as in the previous year which was a year of moderate price increase. Between March 1976 and March 1979 the wholesale price index rose from 162.6 to 189.0 or by an average of 5.4 per cent per year. During this period there were two years which witnessed a high rate of growth in output and one in which output was virtually stagnant. The rapid deposit growth during this period was not allowed to result in a corresponding increase in credit as the additional cash reserve requirements imposed in 1977 were not withdrawn. The credit-deposit ratio of 76.8 per cent in March 1976 was brought down to 65.9 per cent in March 1979, the SLR having been increased during this period only by one percentage point to 34 per cent. It is to be noted that this increase in SLR effected in December 1978 was made applicable to incremental deposits, regardless of excess assets held at the time of introduction of the higher SLR.

8.28 Although the price situation was not a matter of concern during the first half of 1978-79, the expansion in M_3 by 15.8 per cent on an annualised basis in the wake of a 20.6 per cent increase in the previous year had to be taken note of. Mid-way during the first half of 1978-79, banks were subjected to a special deposit requirement on incremental amounts received by them under the two schemes covering remittances from abroad. This measure was aimed at reducing the secondary impact on monetary expansion. The base date for the requirement envisaging immobilisation of fifty per cent of such incremental deposits was June 1, 1978. This measure together with the continuation of additional cash reserve requirement imposed in January 1977, helped restrict expansion in bank credit to 10.8 per cent and in non-food bank credit to 8.2 per cent on an annualised basis, despite the relatively high expansion in M_3 mentioned earlier.

8.29 The second half of 1978-79 commenced with a second successive increase in agricultural output which at 3.9 per cent was notable as it represented a further increase over the 14.2 per cent increase recorded in 1977-78. Food credit declined slightly over the second half of 1978-79 while non-food bank credit rose at a slightly higher pace than in the previous year, the increase being of the order of 31.2 per cent in annualised terms. The rise in M_3 continued to be steep at an annualised rate of 24.7 per cent as against 21.6 per cent in the same period in the previous year. The overall increase in M_3 during 1978-79 was 21.2 per cent which was barely higher than in the previous year.

8.30 For the first time during the period under review, the currency-deposit ratio which was declining quite rapidly from 0.76 in March 1970

to 0.36 in March 1978, registered a nominal decline of only 0.01 between March 1978 and March 1979. This slow decline has been in evidence ever since, pointing to a stable preference for currency on the part of the public and the declining impact of branch expansion by banks on the currency-deposit ratio. The influence of lower deposit rates since March 1978 on the public's preference for currency and on the currency-deposit ratio cannot also be ruled out.

1979-80

8.31 The environment of price stability created by good harvests, continued application of additional cash reserve requirements, and the special deposit arrangements covering remittances from abroad introduced in 1978, came to an end in the first half of 1979-80 when the wholesale price index rose at an annualised rate of as much as 34.1 per cent. Instead of the usual fall during the first half of the year, refinance to banks increased sharply to Rs. 874 crores in September from a level of Rs. 546 crores in March. Food credit rose sharply during this period, and non-food bank credit rose by 18.5 per cent on an annualised basis as compared to the modest 8.2 per cent in the corresponding period of the previous year. The RBI's decision to deny refinance facilities from March 30, 1979 to banks which defaulted in their CRR/SLR obligations was expected to prevent unauthorised expansion in credit but the popularity of participation certificates afforded banks a convenient means of increasing their lending operations without attracting the restrictions attached to bank credit in terms of quantitative credit control. The inflationary impact of participation certificates was not seriously considered till July 1979 when they were brought under the CRR/SLR obligations in a phased manner. The increase in participation certificates outstanding over their level at the end of July 1979 also attracted a reserve stipulation in the form of an additional daily balance of at least 10 per cent of the increase. A more drastic measure to restrain the expansion in bank credit was taken in August 1979. Banks were required to apply an across the board cut on the drawing power against credit limits to the extent of 20 per cent of the peak level utilised during the two year period ending June 1979. This sudden reduction in effective drawing power to 80 per cent of the credit utilised in a past period was an unusual measure indeed. Though it was probably prompted by the certainty of a most severe drought affecting the kharif crop, and its aftermath, the measure could only be inequitous in operation. By September, further monetary restraint measures were in place. Banks were required not to increase the level of their outstanding participation certificates beyond the July 27 level; refinance for food and small farmer finance was made more restrictive. The maximum lending rate of banks was raised by 3 percentage points to 18 per cent for the larger banks, and from 16 per cent to 19 per cent for smaller banks. Simultaneously deposit

rates too were raised, the maximum increase being limited to 1.5 percentage point.

8.32 The series of measures introduced between July and September did not prevent a rise in M_3 of the order of 16.3 per cent in annualised terms during the first half of 1979-80, nor a rise of as much as 18.5 per cent in non-food bank credit on an annualised basis. Possibly, the expectation in regard to a severe drought did not take much time to crystallise into a pre-emptive hoarding of credit which the cut-off point of June 1979 in regard to reduction in drawing power did little to influence. The expectations of widespread crop failure would fuel inflationary expectations like no other single event in the economy, and trade and industry would also, no doubt, substantially anticipate monetary control measures.

8.33 It is interesting to note that all these monetary control measures were found to be necessary during a period when reserve money rose by no more than Rs. 763 crores. The powerful psychological impact of expectations regarding a widespread crop failure on trade and business as also on the general public can be gauged by the events as they unfolded during the first half of 1979-80. The second oil shock further aggravated the situation and inflationary expectations got a strong hold on the economic agents.

8.34 The restrictive measures taken since June 1979, together with the considerably lower level of economic activity associated with the decline in net national product by 5.5. per cent in 1979-80, resulted in bank credit expansion of no more than 18 per cent on annualised basis during the second half of 1979-80. With a decline in food credit during this period, this meant a rise in non-food bank credit at an annualised rate of 28.3 per cent a rate of expansion which was lower than in the corresponding period of the preceding two years. M_3 rose over the second half of 1979-80 at a slightly higher rate than in the first, and for the year as a whole recorded a 17.3 per cent increase which was notably lower than the increase of 21 per cent in the two preceding years.

8.35 The increase in reserve money was substantial at Rs. 2,749 crores over the year, of which the rise in RBI credit to government was as high as Rs. 2,966 crores. For the first time in five years, the trend in net foreign exchange assets of the Reserve Bank was reversed in 1979-80 when there was a decline of Rs. 12 crores. This decline continued in later years till the net foreign exchange assets rose in 1984-85.

8.36 The price rise between March 1979 and March 1980 was 23.4 per cent, the wholesale price index having risen from 189 in March 1979 to 221.2 in September 1979 and 233.2 in March 1980. It is interesting to note that the major part of the increase took place before the failure of the kharif crop and probably very much in anticipation of the failure, despite reasonable levels of carryover stocks of commodities which could be pre-

dicated on the basis of two good agricultural seasons during 1977-79.

1980-81

8.37 The impact of the restrictive monetary policy measures of 1979-80 was very much in evidence during the first half of 1980-81. Bank credit rose by only 4.9 per cent on an annualised basis, while the rate of expansion in M_3 of 11.8 per cent in annualised terms was the lowest since the first half of 1975-76. Nevertheless, the inflationary pressures continued and were reflected in a 26.2 per cent annualised rate of increase in the wholesale price index. The index of industrial production (average of months) declined by 4 per cent during the first half of 1980-81 from its average level during the previous half year reflecting poor supplies of agro-based raw materials and fall in demand following the drought in 1979-80. The sharp rise in prices during the first half of 1980-81 occurred in spite of severe monetary restraint, and reflected supply shortages and the continued rise in oil prices.

8.38 The second half of 1980-81 was characterised by a strong recovery in foodgrains output and in agricultural output in general. The index of industrial production too registered a remarkable rise of 12.5 per cent above its average level in the earlier half of 1980-81, its highest rate of increase in a half year during the past fifteen years. The expectations of a notable increase in net national product, which turned out to be as high as 7.9 per cent for the year, ended anxiety about a continuation of inflationary pressures, prompting the central bank to announce its first major relaxation in monetary control measures during 1980-81 which took the form of termination of the additional cash reserve requirement imposed in January 1977 and continued since then in response to the rapid growth of deposits and the need to contain growth in M_3 within reasonable limits. As a measure of caution, however, the additional cash reserves were not released and they constituted for the time being 'impounded reserves' which were not eligible for meeting normal CRR requirements. This relaxation was taken full advantage of by banks as revealed by the increase in bank credit in annualised terms by 30 per cent and in non-food credit by 33.6 per cent. These rates of expansion were the highest since 1973-74. Deposits too grew rapidly in the second half of 1980-81, and M_3 rose by 23.4 per cent in annualised terms, bringing the growth in M_3 over the year to 18.3 per cent. The low rate of expansion in M_3 during the first half of 1980-81 was probably crucial in limiting the rise in M_3 for the year to slightly above its rate of expansion in the previous year, if account is taken of the unprecedented rise in Reserve Bank credit to government of no less than Rs. 3,698 crores during the year. The good kharif crop and the notable rise in industrial production probably helped in dampening inflationary expectations to such an extent that, despite the rapid increase in M_3 and in bank credit, prices rose by no more than 4.3 per cent on an annualised basis over the second half of 1980-81. For the year as a whole

however, the price rise was indeed of a high order, the wholesale price index rising by 15.6 per cent between March 1980 and March 1981, over and above a 23.4 per cent rise in the previous year.

8.39 Considering that the rise in the wholesale price index on the basis of an average of months was 18.2 per cent in 1980-81 as against 17.1 per cent in the previous year, the timing of the decision to withdraw the additional cash reserve requirement in October 1980 is open to some criticism, particularly since the large fiscal deficit announced at the beginning of the year would have already signalled a steep increase in Reserve Bank credit to government with consequent pressures on monetary expansion which could only be contained by holding a tight rein on the money multiplier. The increase in deposits between September 1980 and March 1981 was no less than Rs. 3,500 crores which exceeded by far the spectacular increase during the second half of 1978-79. A steep rise in deposits would mean a substantial contribution to government through the SLR stipulation and despite such a contribution, the rise in Reserve Bank credit was at an unprecedented level in 1980-81. This only highlights the very effective role played by the additional cash reserve stipulation since 1977 in neutralising a part of the expansionary impact of reserve money growth. The incremental money multiplier (based on annual increases) which was 4.027 in 1977-78 declined to 2.517 and 2.514 in the following two years, but registered a steep increase to 3.684 in 1980-81. In the circumstances a *phased* withdrawal of the additional cash reserve requirements might have better suited the requirements of the price situation.

8.40 In March 1981 the lending rates of banks were rationalised. Following the reimposition of the interest tax the maximum lending rate of the larger banks had earlier been raised in July 1980 to 19.5 per cent per annum representing an increase of 1.5 percentage point. Deposit rates were also raised in March 1981, and notably the maximum deposit rate which was raised by one percentage point to 10 per cent per annum was offered on deposits with a maturity of more than three years. This was a steep increase considering that prior to this change, deposits of minimum 5 year maturity were eligible for the highest rate offered on deposits. This revision in the maximum deposit interest rate towards the end of two years of inflation restored it to its level which prevailed for four years prior to the reduction of one percentage point effected in 1978-79, a year which witnessed no increase in the price level as measured by the wholesale price index (on the basis of average of months).

1981-82

8.41 The index of industrial production declined during the first half of 1981-82, but bank credit and non-food bank credit maintained their

momentum of the previous half year registering a much higher rate of growth than during the first half of the previous year. M_3 expanded at an annualised rate of 12.4 per cent and the wholesale price index rose by 11.4 per cent on an annualised basis. The increase in CRR on July 31, from 6 per cent to 6.5 per cent and further to 7 per cent in August appear to have been well timed to prevent a repetition of the kind of monetary expansion observed in the second half of the previous year. The substantial decline in foreign exchange assets of RBI by as much as Rs. 2,087 crores during the year brought down the expansion in reserve money to Rs. 1,675 crores despite an increase in Reserve Bank credit to government by as much as Rs. 4,435 crores. This period coincided with the Extended Fund Facility arrangements with the IMF and the difficult foreign exchange situation focused attention on arresting inflationary pressures in the economy and the monetary brakes were applied accordingly, the CRR being raised further in November to 7.25 per cent, in December to 7.50 per cent and in January 1982 to 7.75 per cent. Having let bank credit expand at an unusually high rate in the first half, the monetary authorities had to apply a sharp brake on the expansion in the second half to contain the overall growth in bank credit. This they accomplished though not without some undesirable consequences for certain sectors. The rise in bank credit during the second half of 1981-82 was thus restricted to 18.5 per cent on an annualised basis and similarly 17.9 per cent in the case of non-food bank credit. This order of expansion during the second half of a year was the lowest of any year during the last fifteen years, and was brought about despite a 4.9 per cent rise in net national product during the year and an increase of 9.4 per cent in the index of industirial production. The expansion in M_3 during the second half of 1981-82 was virtually the same as that in the first half. The moderate increase in monetary aggregates coupled with better availability of non-food agricultural supplies and industrial goods arrested the rising trend in prices, and brought down the wholesale price index between September 1981 and March 1982 by 5.8 per cent on an annualised basis.

8.42 For the year as a whole M_3 recorded an increase of only 12.8 per cent, the lowest order of increase barring 1974-75 during the last fifteen years, while non-food bank credit rose by 16.7 per cent as compared to 21.5 per cent in the previous year which witnessed a higher rate of growth in output.

8.43 It should also be noted that the lower rate of expansion of non-food bank credit in 1981-82 occurred when the index of industrial production rose markedly by 8.6 per cent. The phased increase in CRR starting November 1981 which was announced in advance was a departure from previous practice, and probably had an additional impact by being percei-

ved by banks and their clients as an indication of the determination of the central bank to regulate monetary expansion within narrow limits. Its impact on inflationary expectations was also probably significant.

1982-83

8.44 The first half of 1982-83 saw a further tightening of monetary controls in the form of a reduction in total refinance facilities brought about partly by raising the refinance threshold for food credit. Although food credit rose by more than Rs. 200 crores between March 1982 and September 1982, refinance levels were brought down from Rs. 831 crores to Rs. 382 crores, the reduction of the order of Rs. 449 crores being the largest since the first half of 1977-78. The continued operation of higher CRR (though the level was being brought down in stages) and the tightening of refinance facilities, as also a decline in industrial production brought down the rate of increase in bank credit to as low as 5 per cent on an annualised basis for non-food bank credit during the first half of 1982-83. The expansion in M_3 of 14.3 per cent in annualised terms during the first half of 1982-83 could be termed moderate considering the relatively low rate of expansion during 1981-82. The rise in prices at an annualised rate of 10.3 per cent was probably more a reflection of the marginal increase in foodgrain production in the previous year and a fall in the index of industrial production by 4.9 per cent during the first half of 1982-83 than an outcome of the moderate monetary expansion referred to earlier.

8.45 A reduction in CRR from 7.75 per cent to 7.25 per cent was effected in April 1982, and followed up with a reduction to 7 per cent in June 1982 though prospects of a good kharif crop were not in evidence and the index of industrial production was in fact declining. As events turned out, the year witnessed a 4.2 per cent decline in agricultural output, and an increase in net national product of no more than 1.6 per cent. Further, reserve money was rising between March 1982 and September 1982 at a slightly higher rate than in the first half of the previous year. The inflationary expectations which were somewhat subdued in 1981-82 were not probably revised in early 1982-83 as evidenced by the nominal expansion in non-food bank credit during the first half of the year. Nevertheless, the relaxation in CRR effected in June 1982 points to the confidence the central bank had in its ability to restrain non-food bank credit expansion by adjusting the threshold for food credit refinance.

8.46 The second half of the year witnessed a sharp increase of 32.2 per cent on an annualised basis in bank credit as also similarly of 30.4 per cent in non-food bank credit, despite a poor performance of the economy in regard to increase in output. M_3 expansion was 17.9 per cent, as against

12.4 per cent in the second half of the previous year. The nominal rise in prices during the second half of the year, following a poor kharif crop and despite a sharp rise in money supply and credit was an unusual development, made possible by strong supply management measures and probably delayed revision of earlier expectations in regard to the repetition of the previous year's experience in regard to price stability.

8.47 The wholesale price index registered a rise of 6.6 per cent between March 1982 and March 1983. While M_3 expansion was of the order of 16.7 per cent the expansion in bank credit at 19.6 per cent was higher than in 1981-82. The rise in reserve money by Rs. 2,647 crores was matched by equivalent increase in Reserve Bank credit to government. The net foreign exchange assets of RBI declined over the year by Rs. 894 crores as against Rs. 2,087 crores in the previous year serving to depress growth in reserve money.

1983-84

8.48 Although additional monetary control measures during the second half of 1982-83 were probably called for by the developments on the output front referred to earlier, their absence did not influence the behaviour of monetary aggregates unfavourably during the first half of 1983-84 as the CRR weapon was used repeatedly between May and August 1983. While M_3 expansion was restricted to 14.9 per cent in annualised terms the rise in non-food bank credit was a modest 5.8 per cent on an annualised basis and similarly the rise in bank credit was no more than 7.2 per cent during the first half of the year. The fall in foodgrains output in 1982-83 was probably instrumental in giving a boost to inflationary pressures which resulted in a price rise of 15.9 per cent on an annualised basis during the first half of 1983-84, despite strong monetary control measures.

8.49 The expansion in reserve money during the first half of the year was Rs. 1,065 crores, considerably higher than the increase of Rs. 601 crores in the previous year which we have already commented on. During the second half of the year reserve money experienced a further large increase of Rs. 4,646 crores. Despite this strong expansionary factor, monetary expansion was restricted to 19.4 per cent on an annualised basis during the second half of the year by using the powerful additional cash reserve stipulation in regard to net demand and time liabilities accruing after November 11, 1983; the additional cash reserve was stipulated at 10 per cent of such liabilities. This additional cash reserve requirement coupled with the prior increase in CRR from 7 per cent to 8.5 per cent in three stages between May and August gave the central bank sufficient flexibility to offset the expansionary impact of the large increase in reserve money,

though it impaired its ability to offset similar increases in reserve money were they to occur in the subsequent periods. During the second half of 1983-84 the bumper kharif harvest of 1983-84, particularly the record foodgrains output, and the increase in the index of industrial production by 11.9 per cent over the previous half year provided a strong anti-inflationary bias in the economy which was reinforced by the monetary control measures just referred to. The rise in the wholesale price index between September 1983 and March 1984 was no more than 3.0 per cent on an annualised basis. Over the year as a whole prices rose by 9.6 per cent and M_3 expansion at 17.9 per cent was slightly higher than in the previous year. The expansion in non-food bank credit was 22.7 per cent in annualised terms during the second half of the year but a modest 14.6 per cent for the year as a whole.

8.50 From the foregoing review of monetary policy measures it is seen that the management of aggregate demand in the context of marked variations in output mainly induced by weather conditions is a complex task made more so periodically by the operation of strong external factors. It appears that a strict vigil over monetary expansion in the first half of the year is essential in order to retain some manoeuvrability in the second half of the year to determine the rate of monetary expansion suited to the rate of growth in output and emerging price trends as signalled by the kharif crop. The central bank also has a difficult task of determining the timing of its regulatory measures on the basis of its experience in regard to the lags involved. As the banking system has grown considerably over the years the cost of a delayed decision can be considerable. Similarly, while monetary brakes are to be applied it is necessary to start early and in a phased manner as the impact of regulatory measures cannot be allowed to be so drastic as to cause unintended hardship to specific sectors of the economy. The instruments such as the Cash Reserve Ratio, and refinance policy have been used often and their continued effectiveness in subsequent periods needs to be preserved through a restructuring of the monetary system. Quantitative controls on credit have become a regular feature and have borne to a large extent the considerable burden of monetary regulation. Considering that these controls depend on moral suasion their effectiveness may continue but can be significantly enhanced if they are not used as a primary instrument of monetary regulation which appears to be a logical outcome unless the flexibility in the use of other instruments is restored early. In the next chapter we undertake an analysis of the factors which have a considerable influence on the functioning of the monetary system and develop a framework suitable for a more effective conduct of monetary policy.

(Rupees Crores)

As at the end of	Wholesale Price Index (a)	M_3	Aggregate Deposits (b)	Total Credit (b)	Food Credit	Non-Food Credit	Refinance	Bankers' Deposits with RBI	Reserve Money
1969									
March	91.0	8306	4338	3396		3396	106	166 (b)	4069
September	96.1	8582	4730	3424		3424	20	161 (b)	
1970									
March	97.1	9337	5028	3970		3970	238	173	4391
September	101.2	9784	5489	4249		4249	189	209	4435
1971									
March	100.3	10958	5906	4684	214 (c)	4470	368	217	4814
September	107.5	11532	6514	4822	368	4454	102	243	4934
1972									
March	108.1	12690	7106	5263	345	4918	207	296	5380
September	117.1	13355	7815	5221	357	4864	4	277	5207
1973									
March	121.9	15033	8643	6115	339	5776	138	297	6015
September	136.5	16277	9619	6314	274	6040	39	760	6662
1974									
March	157.5	17571	10139	7399	367	7032	409	630	7260
September	182.0	18449	11132	7629	277	7352	87	559	6994
1975									
March	174.6	19457	11827	8762	613	8149	473	631	7388
September	177.5	20003	13070	9058	655	8403	189	550	7229
1976									
March	162.6	22286	14155	10877	1521	9356	798	631	7732
September	179.5	24851	16081	11866	2110	9756	870	865	8386
1977									
March	182.9	27279	17566	13173	2190	10983	967	1176	9544
September	188.2	29591	19694	13623	2321	11302	319	1407	9867

Table 2 : Money, Credit and Prices (1969-1984)

(Rupees Crores)

As at the end of	Wholesale Price Index (a)	M_3	Aggregate Deposits (b)	Total Credit (b)	Food Credit	Non-Food Credit	Refinance	Bankers' Deposits with RBI	Reserve Money
1978									
March	182.9	32905	22211	14939	1984	12955	331	1719	10941
September	186.6	35509	24107	15748	2265	13483	244	2027	11704
1979									
March	189.0	39890	27016	17795	2210	15585	546	2686	13716
September	221.2	43140	29814	19759	2733	17026	874	3225	14479
1980									
March	233.2	46801	31759	21537	2100	19437	739	3685	16465
September	263.8	49560	34484	22060	1849	20211	458	3582	16143
1981									
March	269.5	55358	37988	25371	1759	23612	589	4163	18788
September	284.8	58789	41585	27164	1876	25288	586	4765	19050
1982									
March	276.4	62426	43733	29681	2127	27554	831	4947	20463
September	290.6	66888	47565	30569	2332	28237	382	5198	21064
1983									
March	294.7	72868	51358	35493	2964	32529	815	5285	23110
September	318.2	78291	56222	36777	3303	33474	405	5929	24175
1984									
March	322.9	85897	60596	41294	4022	37272	1336	7898	28821

(a) Base 1970-71 = 100

(b) Data relate to only scheduled commercial banks.

(c) Data prior to this period are not available.

Sources : Report on Currency and Finance (Reserve Bank of India).
H. L. Chandok, Wholesale Prices in India.

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84)

Per cent Variation	1969-70			1970-71			1971-72		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Wholesale Price Index (a)	11.2	2.1	6.7	8.4	–1.8	3.3	14.4	1.1	7.8
Net National Product (b)			6.2			5.6			1.4
M_3	6.6	17.6	12.4	9.6	16.5	13.7	10.5	20.1	15.8
Aggregate Deposits	18.1	12.6	15.9	18.3	15.2	17.5	20.6	18.2	20.3
Total Credit	1.6	31.9	16.9	14.1	20.5	18.0	5.9	18.3	12.4
Non-Food Credit							–0.7	20.8	10.0
Credit-Deposit Ratio (%) (c)	72.4	79.0	79.0	77.4	79.3	79.3	74.0	74.1	74.1
Food Credit (Rs. Crores) (+ Incr/–Decr)							+154	–23	+131
Agricultural Production (d)			6.7			7.4			–0.3
Industrial Production (e)									
Refinance (Rs. Crores) (+Incr/–Decr) (c)	+37	–86	+132	+218	–49	+130	–266	+105	–161
Bankers' Deposits with RBI (c) (Rs. Crores) (+ Incr/–Decr)	–5	+12	+7	+36	–8	+44	+26	+53	+79
Lending Rates of Banks									
Minimum (%)									
Maximum (%)									
Cash Reserve Ratio (%)			3			3			3
Additional Cash Reserve Ratio									
Currency-Deposit Ratio (Level)			0.76			0.67			0.61

Notes : I refers to first half year (end March to end September) and II refers to second half year (end September to end March). Percentage Variations are annualised.
Data on bank credit relate only to scheduled commercial banks.
Additional notes are at the end of the Table.

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84) (Contd.)

Per cent Variation	1972-73			1973-74			1974-75		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Wholesale Price Index (a)	16.6	8.2	12.8	24.0	30.8	29.2	31.1	–8.2	10.9
Net National Product (b)			–1.5			5.2			1.5
M_3	10.5	25.5	18.5	16.6	15.9	16.9	10.0	10.9	10.7
Aggregate Deposits	20.0	21.2	21.6	22.6	10.8	17.3	19.6	12.5	16.6
Total Credit	–1.6	34.2	16.2	6.5	34.4	21.0	6.2	29.7	18.4
Non-food Credit	–2.2	37.5	17.4	9.1	32.8	21.7	9.1	21.7	15.9
Credit-Deposit Ratio (%) (c)	66.8	70.8	70.8	65.6	73.0	73.0	68.5	74.1	74.1
Food Credit (Rs. Crores) (+ Incr/–Decr)	+12	–18	–6	–65	+93	+28	–90	+336	+246
Agricultural Production (d)			–8.0			9.9			–3.2
Industrial Production (e)	–2.2	5.0	4.0	–3.6	6.6	2.0	–3.7	6.2	2.5
Refinance (Rs. Crores) (+ Incr/–Decr)	–203	+134	–69	–99	+370	+271	-322	+386	+64
Bankers' Deposits with RBI (c) (Rs. Crores) (+ Incr/–Decr)	–19	+20	+1	+463	–130	+333	–71	+72	+1
Lending Rates of Banks									
Minimum (%)				10.0 (June)	11.0 (Dec.)		12.5 (July)		
Maximum (%)									
Cash Reserve Ratio (%)			3	5 (May) 7 (Sep.)			5 (June)	4 (Dec.)	
Additional Cash Reserve Ratio (%)									
Currency-Deposit Ratio (Level)			0.57			0.56			0.49

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84) (Contd.)

Per cent Variation	1975-76			1976-77			1977-78		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Wholesale Price Index (a)	3.3	–16.8	–6.9	20.8	3.8	12.5	5.8	–5.6	0.0
Net National Product (b)			9.8			0.5			9.1
M_3	5.6	22.8	14.5	23.0	19.5	22.4	17.0	22.4	20.6
Aggregate Deposits	21.0	16.6	19.7	27.2	18.5	24.1	24.2	25.6	26.4
Total Credit	6.8	40.2	24.1	18.2	22.0	21.1	6.8	19.3	13.4
Non-food Credit	6.2	22.7	14.8	8.6	25.2	17.4	5.8	29.2	18.0
Credit-Deposit Ratio (%) (c)	69.3	76.8	76.8	73.8	75.0	75.0	69.2	67.3	67.3
Food Credit (Rs. Crores) (+ Incr/–Decr)	+42	+866	+908	+589	+80	+669	+131	–337	–206
Agricultural Production (d)			15.0			–6.8			14.2
Industrial Production (e)	–3.0	11.9	5.9	0.03	9.3	10.6	–4.7	7.7	3.4
Refinance (Rs. Crores) (+ Incr/–Decr)	–284	+609	+325	+72	+97	+169	–648	+12	–636
Bankers' Deposits with RBI (c) (Rs. Crores) (+ Incr/–Decr)	–81	+81	0	+234	+311	+545	+231	+312	+543
Lending Rates of Banks									
Minimum (%)			12.5			12.5			12.5
Maximum (%)		16.5 (Mar.)				16.5		15.0 (Mar.)	
Cash Reserve Ratio (%)			4	5 (Sep.)	6 (Nov.)				6
Additional Cash Reserve Ratio (%)					Introduced (Jan.)				
Currency-Deposit Ratio (Level)			0.43			0.41			0.36

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84) (Contd.)

Per cent Variation	1978-79			1979-80			1980-81		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Wholesale Price Index (a)	4.0	2.5	3.3	34.1	10.8	23.4	26.2	4.3	15.6
Net National Product (b)			5.6			–5.5			7.9
M_3	15.8	24.7	21.2	16.3	17.0	17.3	11.8	23.4	18.3
Aggregate Deposits	17.1	24.1	21.1	20.7	13.0	17.6	17.2	20.3	19.6
Total Credit	10.8	26.0	19.1	22.1	18.0	21.0	4.9	30.0	17.8
Non-food Credit	8.2	31.2	20.3	18.5	28.3	24.7	8.0	33.6	21.5
Credit-Deposit Ratio (%) (c)	65.3	65.9	65.9	66.3	67.8	67.8	64.0	66.8	66.8
Food Credit (Rs. Crores) (+Incr/–Decr)	+281	–55	+226	+523	–633	–110	–251	–90	–341
Agricultural Production (d)			3.9			–15.2			15.7
Industrial Production (e)	0.3	6.9	7.6	–6.4	4.0	–1.4	–4.0	12.5	4.0
Refinance (Rs. Crores (+Incr/–Decr)	–87	+302	+215	+328	–135	–193	–281	+131	–150
Bankers' Deposits with RBI (c) (Rs. Crores) (+Incr/–Decr)	+308	+659	+967	+539	+460	+999	–103	+581	+478
Lending Rates of Banks									
Minimum (%)			12.5			12.5	13.5 (July)	(g)	
Maximum (%)			15.0	18.0 (Sept.)			19.5 (July)		
Cash Reserve Ratio (%)			6			6			6
Additional Cash Reserve Ratio (%)			Continued			Continued		Withdrawn (Oct.)	

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84) (Contd.)

Per cent Variation	1981-82			1982-83			1983-84		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Wholesale Price Index (a)	11.4	–5.8	2.6	10.3	2.8	6.6	15.9	3.0	9.6
Net National Product (b)			4.9			1.6			7.6
M_3	12.4	12.4	12.8	14.3	17.9	16.7	14.9	19.4	17.9
Aggregate Deposits	18.9	10.3	15.1	17.5	15.9	17.4	18.9	15.6	18.0
Total Credit	14.1	18.5	17.0	6.0	32.2	19.6	7.2	24.6	16.3
Non-Food Credit	14.2	17.9	16.7	5.0	30.4	18.1	5.8	22.7	14.6
Credit-Deposit Ratio (%) (c)	65.3	67.9	67.9	64.3	69.1	69.1	65.4	68.1	68.1
Food Credit (Rs. Crores) (+ Incr/–Decr)	+117	+251	+368	+205	+632	+837	+339	+719	+1058
Agricultural Production (d)			5.5			–4.2			13.7
Industrial Production (e)	–2.0	9.4	8.6	–4.9	9.1	3.9	–4.6	11.9	5.9
Refinance (Rs. Crores) (+ Incr/–Decr)	–3	+245	+242	–449	+433	–16	–410	+931	+521

Table 3 : Variations in Money, Credit and Prices and Selected Monetary Policy Indicators (1969-84) (Conclud.)

Per cent Variation	1981-82			1982-83			1983-84		
	I	II	Full Year	I	II	Full Year	I	II	Full Year
Bankers' Deposits with RBI (c) (Rs. Crores) (+ Incr/–Decr)	+602	+182	+784	+251	+87	+338	+644	+1969	+2613
Lending Rates of Banks									
Minimum (%)									
Maximum (%)			19.5			19.5	18.0 (April)		
Cash Reserve Ratio (%)	6.5 (July) 7.0 (Aug.)	7.25 (Nov.) 7.50 (Dec.) 7.75 (Jan.)		7.25 (Apr.) 7.00 (June)			7.50 (May) 8.0 (July) 8.5 (Aug.)	9.0 (Feb.)	
Additional Cash Reserve Ratio (%)								Intro-duced (Nov.)	
Currency-Deposit Ratio (Level)			0.30			0.30			0.30

Notes :

(a) Base 1970-71 = 100.
(b) At factor cost, at 1970-71 prices.
(c) As at the end of September (First half year) and March (Second half year).
(d) Triennium ending 1969-70 = 100, (July-June).
(e) Base 1970 = 100 (Average of Weeks).
(f) Data prior to this period are not available.
(g) No general minimum lending rate from March 1981.

Chapter 9 : THE ANALYTICAL FRAMEWORK

Having reviewed the salient features of the Indian monetary system in the foregoing chapters, we proceed to develop an approach for undertaking a restructuring of the monetary system. Before we do so, we shall examine the theoretical considerations having a bearing on the task before us.

The Relationships between Money, Output and Prices

9.2 The precise inter-relationships between money, output and prices have, despite years of research, remained an area of controversy. It is, therefore, not surprising that there is no consensus among monetary economists on how money influences the economic system. The channels of transmission are still a subject matter of continuing debate.

9.3 The inter-action between money, output and prices is very often summarised in one equation which takes the form of the demand function for real money balances. Nominal money balances held by the public are deflated by a price index representing the general price level and the real money balances are treated as a function of real income and the return on alternative financial assets. Thus, the typical demand function for real money balances runs as follows:

$$M/P = f(Y_r, i)$$

Where M stands for nominal money held by the public, P for price level, Y_r for real income and i for interest rate. It is possible to build into such a formulation the lagged impact of the factors influencing money holding.

9.4 In this type of formulation, the demand for holding money balances springs from motives which Keynes dealt with extensively.* The increase in real income, *ceteris paribus,* necessitates an increase in the demand for real money balances and so long as money supply expands to this extent, there is no increase in the price level. In fact the demand function for money can be re-stated as a price equation and can be formulated as follows, if it is assumed that the demand for money is not significantly influenced by the rate of interest.

$$P = a - bY_r + c\,M$$

According to this formulation, an increase in real output depresses the price level and an increase in money supply raises the price level.

* Of course, there are other approaches which treat the demand for money as part of capital or wealth theory concerned with the composition of the balance sheet or the portfolio of assets. However, in almost all the formulations, ultimately money holding is treated as resting on the two basic variables, income and rate of return, even though the underlying reasoning is different in different approaches.

9.5 The demand function for money is based on the postulate that the causation runs from real income to money. It is accordingly, implicitly assumed that real income itself remains uninfluenced by changes in money. It basically ignores what is sometimes called the "credit view". The process of money creation is simultaneously a process of credit creation. Money which is a liability either of the central bank or the commercial banks can come into existence only when an increase takes place in the assets of these institutions, which are mainly in the form of loans. The demand function for money of the type indicated here ignores the link between output and credit inherent in the process of production.

9.6 It is thus necessary also to look upon the problem from the credit side since an output increase may require a certain amount of increase in credit. While the increase in credit is meant to facilitate creation of output, increase in credit simultaneously leads to monetary expansion. However, the impact on prices of any such expansion is neutralised by the increase in output which such an expansion helps to generate.

9.7 The extent of increase in the price level associated with an increase in output and money will depend on the elasticity of output with respect to credit and the elasticity of price with respect to money as well as output. Obviously these elasticities themselves depend upon the structure of production and the flexibility of supply responses and can change with time.

9.8 It is, therefore, useful to conceive of the problem in a framework of a macro model focusing on the relation between output and credit on the one hand, and between prices, and output and money on the other. Apart from the demand function for money the model will have a supply function which will relate the increase in nominal money supply to an increase in "high powered" money of which an important element is the central bank credit to government, arising out of the need to finance a high level of government investment. Further, the link between increase in real output and credit can be postulated, giving due recognition to the important role of government investment and central bank credit to government. There are models which in some way attempt to do so. However, critical to this type of analysis is the part played by central bank credit in financing public investment.

9.9 An important area of concern to the monetary authority is the determination of the rate of growth of money supply, taking into account the inter-relationship of the type discussed above.* In order to be acceptable to the monetary authority, the rate of growth in money supply should be in conformity with the desired rate of growth in output and constrain the price increase to an acceptable level. The reliance, more or less

* It is interesting to note that, when deriving its annual monetary growth targets, the Deutsche Bundesbank specifically takes into account the following variables: "a) The expected growth in the production potential, b) the desired change in the utilisation of the production potential c) The 'unavoidable' rise in prices, and d) The expected development of the 'velocity of circulation' of money i.e. the relationship between the gross national product and the money stock." (Deutsche Bundesbank, Special Series No.7) p.84.

exclusively, on the demand function for money (or the price equation) in determining the appropriate rate of growth in money supply is based on the assumption that this function can be treated as some kind of reduced form equation incorporating the inter-actions mentioned above. From the operational point of view, without going into causation, it may be possible for the monetary authority to use such an equation to regulate the supply of money. The problem then becomes one of obtaining satisfactory empirical evidence over time in respect of the elasticities involved in the demand for money function.

9.10 A number of empirical studies have been undertaken to investigate the nature of the demand for money in developing countries. Most of these studies support the hypothesis that the demand function for money is stable. This functional stability as distinguished from numerical stability does not, however, preclude shifts in the parameters over a period of time as the institutional framework in a country undergoes a change. In India also there have been several attempts over the years to estimate the demand for money taking either the narrow definition or the broad definition of money. Further, in some of the studies the demand for money has been analysed by the components of money e.g. currency, demand deposits and time deposits. The major explanatory variables included in the demand function are real income, relative shares of agricultural and non-agricultural incomes, interest rate on time deposits, yield on ordinary shares, yield on long term government bonds, expected rate of inflation and degree of monetisation. Empirical studies of the demand for money show that real income is the predominant factor in explaining the demand for money. The demand for money is, understandably, not found to be very sensitive to interest rates in India in the context of a system of administered interest rates, while inflation is found to have an impact on the demand for real money balances. This is an area calling for continuing research on the part of monetary economists and the monetary authority.

9.11 Looking at the growth of money stock from the supply side, the following equation can be written highlighting the relation between money stock, on the one hand, and reserve money and the money multiplier on the other.

$M^s = m.RM$,

Where

M^s : supply of money in nominal terms,
m : money multiplier
RM : reserve money or monetary base,

The value of the money multiplier depends on the currency-deposit ratio and factors determining the cash reserves of the banks. Changes in the

value of the money multiplier and in the level of reserve money lead to corresponding changes in the money stock.

9.12 With the significant expansion of the network of bank branches in India since the early Seventies, the currency-deposit ratio has fallen steadily. The falling currency-deposit ratio has increased the value of the money multiplier for M_3.

9.13 Studies on money multiplier show that it is predictable on a quarterly basis. The studies also show that the value of the money multiplier is influenced significantly by the lagged effect of the explanatory variables. Consequently, policy action to change the value of the money multiplier will result in lagged effects on future values of the money multiplier which must be taken into account while formulating monetary policy.

9.14 The decline in the currency-deposit ratio has been less pronounced in recent years. To what extent a further decline in the ratio can be achieved through expansion of the branch network in the absence of a major change in the payments system encouraging greater use of cheques is a difficult question to answer. We might hazard a guess that any significant decline in the currency-deposit ratio in the foreseeable future is not likely to be achieved, particularly in view of the growing volume of competing financial assets which are likely to reduce the growth rate of bank deposits, and the necessarily slow process of bringing about changes in the payments system covering a large country like India. Determining the acceptable rate of growth of money supply referred to earlier would tantamount to determining the growth of reserve money adjusted for changes in the reserve ratio.

Objectives of Monetary Policy

9.15 The course of Indian economic development since the early Fifties has been charted in the successive Five Year Plans. There has been an essential continuity in the objectives of planning, though the relative emphasis on specific objectives has varied from one Plan to another. Growth with stability, social justice, removal of poverty and achievement of self-reliance are objectives which continue to receive the highest priority in the formulation of successive Five Year Plans. As noted earlier, in more recent years other related objectives such as modernisation, the need to create larger employment opportunities in the rural areas, and increasing productivity have also occupied the increasing attention of policy makers.

9.16 The functioning of the monetary system must necessarily be in consonance with the national development strategy as articulated in the successive Five Year Plans. The monetary system should, therefore, seek to perform the following tasks:

(a) mobilising the savings of the community and enlarging the

financial savings pool.

(b) promoting efficiency in the allocation of the savings of the community to relatively more productive purposes in accordance with national economic goals.

(c) enabling the resource needs of the major 'entrepreneur' in the country, viz. the government, to be met in adequate measure.

(d) promoting price stability.

(e) promoting an efficient payments system.

9.17 In order to enable the monetary system to function effectively and accomplish the above tasks it is most essential to ensure that there is no mis-match between the responsibility of the central bank, i.e. the RBI, to supervise and control the functioning of the monetary system on the one hand, and its authority to do so on the other.

9.18 The strong inflationary pressures witnessed in the Seventies have focused attention on the imperative need to pursue developmental strategies in a framework of price stability. The Sixth Five Year Plan recognised that "A major task of economic policy in the Sixth Plan is to create the necessary conditions for the mobilisation of resources for development in a non-inflationary manner. The control of inflation and generation of stable price expectations are crucial for a successful implementation of the Plan. However, anti-inflationary policies must be so devised as to facilitate basic structural changes which are essential for a progressive increase in the country's productive potential........... A great deal of ingenuity will be needed to devise effective economic policies to cope with inflationary pressures."*

9.19 The need to achieve a more favourable capital-output ratio in the face of resource constraints and accordingly the need to improve the performance of the economy through the removal of infrastructural bottlenecks adversely affecting the growth in output have led to the adoption of increased productivity as a major objective of the Seventh Plan as enunciated in the "Approach paper to the Seventh Plan." This approach underscores the importance of ensuring that development expenditures are more directly linked to the creation of additional output than heretofore and are financed in a non-inflationary manner. The growth target indicated in the Approach Paper is predicated on the achievement of a high saving rate. Unless a climate of price stability prevails and inflationary expectations are dampened, mobilisation of savings as envisaged in the Plan could prove to be a difficult task. Improvement in productivity has to be achieved in the organised sector within the framework of nego-

* Sixth Five Year Plan (Planning Commission, Government of India).p 76.

tiated wage settlements which have a bearing on the cost structure in the organised sector of the economy. As such, price stability becomes a crucial factor in forging a link between increase in productivity and negotiated wage settlements. As the proportion of the economy under the organised system increases, the need for a more conscious pursuit of price stability as an objective becomes even more important. To some extent in the past price rises have been moderated because of the inability of the informal sector to adjust its prices sufficiently during inflation.

9.20 The Plan objectives of removal of poverty and achieving growth with social justice and equity also imply, as noted earlier in Chapter 2, due recognition of the imperative need to maintain price stability so that the benefits of growth may reach the poor without being eroded by rising prices of essential commodities and services or by distortions in relative prices.

9.21 The increasing openness of the economy, the need to service external debt, and the importance of improving the competitiveness of non-traditional exports in a highly competitive external environment, require that the domestic price level is not allowed to rise unduly, particularly since our major trading partners have had notable success in recent years in achieving price stability.

9.22 In the Indian context, growth in output is still influenced significantly by the behaviour of the monsoon. Substantial imports of oil and industrial goods and raw materials could periodically expose domestic prices to the rise in prices abroad. In these circumstances, strong domestic inflationary pressures can arise quite suddenly and gather momentum. The control of such inflationary pressures would, in the first instance, require prompt and effective demand management measures so that inflation does not get out of hand even as measures involving actions on the supply side are being implemented to reverse inflationary expectations. Aggregate demand management is an important area of action for the monetary authority which, therefore, should always be in a position to react quickly and decisively to early warning signals of inflation.

9.23 In view of the above considerations it would be desirable, in the Indian context, to assign to the monetary authority a major role in promoting price stability, and also to accord price stability a dominant position in the spectrum of objectives pursued by the monetary authority.

9.24 It should, however, be recognised that the pursuit of the various tasks assigned to the monetary system stated earlier does involve trade-offs among the objectives. Active pursuit of the growth objective may lead to inflationary pressures. Aggressive efforts to increase the share of savings held in the form of financial assets may be reflected in pushing up the cost

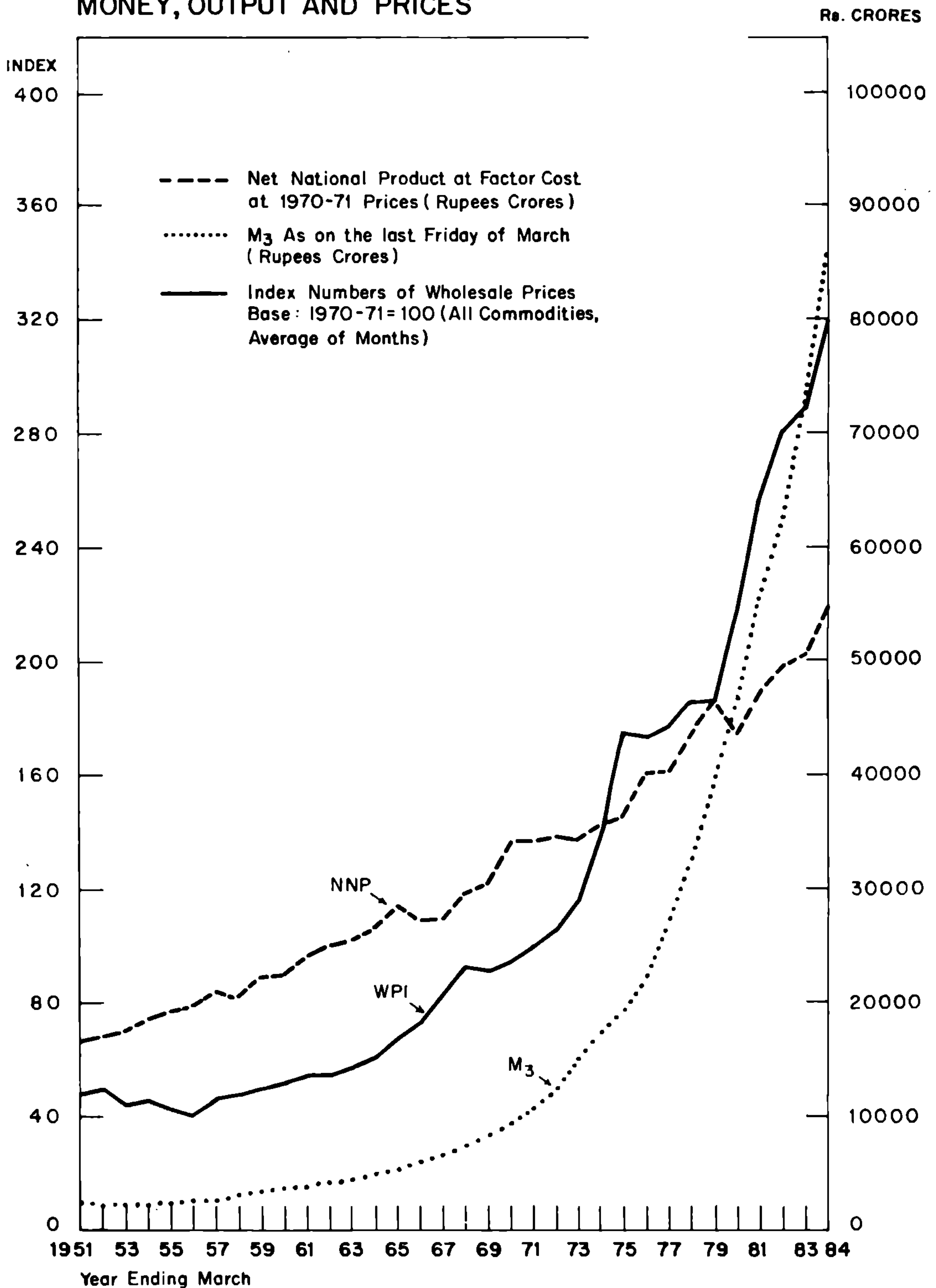
of funds to a level which might dampen investment activity. Channelling the resources of the monetary system to one sector, either the government or the non-government sector, in relatively greater measure can be achieved only by tolerating a reduction in the resources made available to the other, leading to adverse effects on the growth of both the sectors as they are closely inter-related. Such trade-offs are more prominent in the short-run and need to be taken into account in the conduct of monetary policy. They do not, however, call for any alteration in the basic thrust of monetary policy indicated earlier as, in the long run, there is essential compatibility among the various objectives of monetary policy; in particular, the price stability objective becomes a necessary condition for the successful implementation of other objectives including the growth objective.

9.25 Pursuit of price stability in the broadest sense as the dominant objective by the monetary authority consistent with the other goals of national socio-economic policy as embodied in the Five Year Plans should, therefore, provide the basic frame for the conduct of monetary policy in a developing economy like that of India. The other major objectives of monetary policy will, in fact, come into sharper focus when viewed in the perspective of overall price stability.

Money Supply Growth and its Regulation

9.26 Traditionally, regulation of the volume of money and credit in the economy has been a basic function of monetary authorities. The choice of a monetary indicator like money supply, or alternatively, interest rates, has been considered necessary for the effective conduct of monetary policy because changes in key economic variables like output and prices are a result of many complex forces in the economy like the behaviour of enterpreneurs and labour. Further, the transmission mechanism of monetary policy is itself a complex process. Monetary indicators are, therefore, needed to study the immediate impact of monetary policy. In the context of administered interest rates the rate of interest could hardly serve as a target variable. Behaviour of money supply and credit has, therefore, been taken as an important indicator of the stance of monetary policy in India during the past fifteen years.

9.27 The growth of money supply in recent years has been much higher than the growth in output. Money supply (M_3) increased from Rs. 10958 crores in March 1971 to as much as Rs. 85897 crores in March 1984. The wholesale price index rose from 100.3 (base 1970-71=100) to 322.9 during the same period. The average annual growth in output (net national product at factor cost at 1970-71 prices) between 1970-71 and 1983-84 was 3.7 per cent per annum. In comparison, the increase was 17.2 per cent in M_3 and 9.8 per cent in the wholesale price index, on an average annual


MONEY, OUTPUT AND PRICES
Rs. CRORES
INDEX
400
360
320
280
240
200
160
120
80
40
0
100000
90000
80000
70000
60000
50000
40000
30000
20000
10000
0
Net National Product at Factor Cost at 1970-71 Prices (Rupees Crores)
M3 As on the last Friday of March (Rupees Crores)
Index Numbers of Wholesale Prices Base: 1970-71=100 (All Commodities, Average of Months)
NNP
WPI
M3
1951
53
55
57
59
61
63
65
67
69
71
73
75
77
79
81
83
84
Year Ending March

basis between March 1971 and March 1984. The relative movements in money supply, prices and output since the early Seventies have focused attention on the need to devise suitable policies to achieve growth with stability. As mentioned earlier the contribution of monetary policy to the control of inflationary pressures largely lies in the area of aggregate demand management and in facilitating allocation and effective utilisation of credit in relatively more productive avenues.

9.28 A discussion on the feasibility of controlling inflation through demand management measures primarily involving control of money supply raises questions relating to the exogeneity or endogeneity of money supply. Some economists recommend control of expansion in high powered money and hence control of money supply growth as a means to control inflation. In India, the growth of high powered money or reserve money has been largely the result of increase in Reserve Bank credit to government. Any measure to check reserve money growth and hence money supply would, therefore, evidently impinge on the government's freedom to take recourse to central bank accommodation. The inability of the Reserve Bank to deny or regulate credit to government, due to both legal and practical considerations, has been interpreted as an important factor contributing to Reserve Bank's lack of control over reserve money and hence on money supply. The conclusion is, therefore, drawn that monetary policy has had no effective role to play in the control of inflation in the Indian context.

9.29 It has also been argued that curtailing money supply growth might adversely affect output. The creation of output is itself associated with a growth in credit and money supply and it is hard to determine the precise rate of growth in credit and money supply which permits desired output creation without affecting price stability. These arguments lead to policy prescriptions in the area of removing supply bottlenecks (which might well result in additional credit creation and hence growth in money supply) on the one hand and demand management on the other in order to contain the rise in the general price level while attempting to achieve the desired level of growth in output.

9.30 The resolution of the above controversy in regard to the right policy action to control inflation is made more difficult since the validity of the various arguments needs to be considered in the short run as also in the long run. The validity of the arguments of the school that favours control of inflation purely through control of money supply, may probably be more easy to concede in the short run than in the long run, assuming that the Reserve Bank is in fact in a position to control growth of reserve money. The success of policy action aimed at removing supply bottlenecks is again more easily conceded in the long run. But the 'long run' can

only be a succession of 'short runs'. The 'correct' mix of short term policy measures to control inflation while maintaining the desired rate of growth in output over the long run remains elusive. This is the crux of the problem.

9.31 The above debate on alternative policy measures to control inflation is, therefore, not easily resolved and has the effect of creating uncertainty in the minds of policy makers as to the right course of action to achieve growth with price stability. An effort has, therefore, to be made to evolve a suitable framework for undertaking anti-inflationary policies to facilitate an effective pursuit of the basic national objective of growth with price stability. It would appear that such efforts have been thwarted so far by undue reliance on analysis at the aggregative levels. The Indian experience in regard to price behaviour shows that inflationary pressures are generated by a simultaneous operation of several forces. For example, in the case of agricultural commodities, administered prices and supply-demand factors have a dominant impact on price behaviour while prices of industrial products are eventually influenced by cost-push factors. Prices of infrastructural goods and services, are policy determined and probably exhibit a lagged response to cost-push factors. It must therefore, be recognised that price increases cannot be readily attributed to factors influencing only supply, or only demand. Empirical investigation of the issues raised in the above debate is, therefore, not easy at the aggregative level. At a disaggregated level there is perhaps more room for agreement as to policy actions. Proponents of the view that curtailing aggregate government expenditures and deficits would adversely affect output, would not deny that there is considerable scope for reducing inefficiency in the government expenditure programme. A curtailment of aggregate government expenditure might partly result in the curtailment of infructuous expenditure and to that extent there need not be any adverse impact on output, although this will lower growth in reserve money and money supply. Similarly, control of reserve money growth need not necessarily result in lower government expenditures and deficits in the Indian context. This is so because there is considerable scope to reduce monetisation of government debt by adopting suitable financing policies.

9.32 A feasible approach to evolving a policy framework for ensuring a desired rate of growth of government expenditure as well as a desired rate of growth of reserve money and money supply involves a certain degree of co-ordination between government and the Reserve Bank in evolving and implementing agreed policies. Such co-ordination is essential and also feasible. The experience of the last fifteen years has shown that when occasion demands government has played even a dominant role in containing inflationary pressures. In normal times, however, its major pre-

occupation in the economic field is to play the role of a large entrepreneur in the country.

9.33 Both government and the Reserve Bank would thus be required to show due concern for the achievement of the price stability objective which must underlie government actions aimed at raising output levels and Reserve Bank's actions relating to the control of expansion in reserve money and money supply. The problem of controlling the growth in reserve money and in money supply may now be more closely examined.

9.34 As mentioned earlier, the Indian economy, subject as it is to supply shocks by way of failures in agricultural production, is exposed to periodic spurts in prices. Prices have not, however, exhibited any significant downward flexibility in years of good harvests. There is, therefore, an inbuilt upward pressure on prices in India. Imported inflation too has contributed to some extent to increases in the general price level in the Seventies. Neverthless, the substantial rise in the price level since the early Seventies probably cannot be entirely explained by failures in agriculture, and imported inflation. The large deficits incurred by government and financed by the Reserve Bank have led to a significant rise in money supply relative to output, in successive years and have consequently fuelled inflationary pressures during the Seventies. It must, however, be noted that considerable success was achieved during 1974-1976 in keeping the price rise very much under check through strong fiscal measures supported by severe restraint on monetary expansion. Again, during 1978-79 favourable supplies of agricultural commodities contributed to price stability despite considerable monetary expansion.

9.35 Therefore, while recognising the importance of supply factors in framing any policy aimed at price stability, it is necessary also to evolve a framework for ensuring that increases in money supply are not too far out of alignment with year to year growth in output. The latter involves co-ordinated action by government and the Reserve Bank in the field of demand management and more effective use of credit.

9.36 Growth in government expenditures over the last fifteen years has been accompanied by growth in Reserve Bank credit to government. The marked increase in market borrowings and in open budgetary deficits during these years has been associated with a rise in the monetisation of debt and in the holdings of Treasury Bills by the Reserve Bank. The latter are not necessarily an unavoidable consequence of government deficits. One could think of policy actions to reduce the reliance of government on the Reserve Bank for monetary resources, and thereby reduce Reserve Bank credit to government.

9.37 The objective of growth with social justice can be achieved in the context of reasonable price stability only when the compulsions of demand management are adequately reflected in the level of the government's fiscal deficit financed by RBI. Here the phrase 'fiscal deficit' is intended to cover the total domestic borrowing requirements of government as distinguished from Budgetary deficits which refer mainly to changes in the amount of Treasury Bills outstanding and to changes in government's deposit balances with the Reserve Bank and in its other cash balances. On the basis of estimated receipts, including external borrowing, the level of government expenditures needs to be so planned that the resultant domestic borrowing requirements do not result in an excessive increase in money supply in relation to realised output. In order to do so the government needs to explore better the borrowing options available to it than it has been doing at present. The aim should be to regulate the residual reliance on the Reserve Bank for funds in such a way that the resultant growth in reserve money and money supply do not lead to inflation with adverse feedback effects on the level of government expenditure and deficits themselves.

9.38 There appears to be considerable scope for government to tap the savings of the public through an appropriate interest rate structure and offer of a wider spectrum of savings instruments with attractive features. This will have the desirable consequence of lowering the rate of expansion in reserve money and money supply associated with a given level of borrowing by the government.

9.39 The control of monetary expansion in the manner described above, in the interest of price stability, therefore, need not run counter to the growth objective which provides the primary justification for borrowing from the central bank.

9.40 The Budgetary deficit as defined at present does not reveal the full extent of the government's reliance on Reserve Bank credit. A sizeable part of new issues of government securities is taken up by the Reserve Bank in the absence of adequate response from the public and the financial institutions including banks. The effects of the resultant increase in reserve money are no different than what would be the case if Reserve Bank credit was obtained against sale of Treasury Bills. The latter would, however, make an important difference to the Budgetary deficit. In these circumstances excluding additions to Reserve Bank's holding of dated securities from the Budgetary deficit as currently defined severely understates the monetary impact of fiscal operations. A suitable modification in the definition of the Budgetary deficit, therefore, appears to be warranted. In this connection it should also be noted that the Budgetary deficit as currently defined would overstate the monetary impact of fiscal operations if Treasury Bills happen to be held predominantly by the public, and

not by the Reserve Bank as is the case at present. An unambiguous, and economically meaningful measure of the monetary impact of fiscal operations is provided by the change in Reserve Bank credit to government.

9.41 Reserve Bank credit to government gives the full picture as regards the impact of fiscal operations on changes in reserve money, but this impact cannot be readily gauged at the time the government presents its annual Budget for the ensuing year. This is because the likely level of subscriptions by the public as also banks and other financial institutions to new issues of government securities or Treasury Bills are not known with any certainty at the time the borrowing programme of the government is presented as a part of the Budget, and hence the reliance on the Reserve Bank, being of a residual nature, is also not known with any degree of certainty.

9.42 The scale of borrowing by government as announced in the Budget, however, focuses attention on the crucial difference between budgeted expenditures and expected revenues and, therefore, facilitates an analysis of the policy measures that need to be undertaken to confine recourse to Reserve Bank credit to any pre-determined level.

9.43 An analysis of the limits to monetary expansion in a given year based on the expected growth of output and an assessment of the price situation is therefore necessary in order to determine the 'safe' limit for expansion of reserve money from the point of view of price stability. The share of credit to government out of this increase in reserve money could then be determined. Advance knowledge of the extent of Reserve Bank credit which it could safely utilise to meet any shortfall in resources would enable the government to draw up a realistic borrowing programme to meet the resource gap.

9.44 The above approach would provide the necessary framework for co-ordination between the government and the central bank in regard to the determination of the desired level of borrowing from the central bank (and hence the Budgetary deficit according to the definition suggested by us) on the one hand, and the acceptable rate of monetary expansion on the other. On the basis of such co-ordination the monetary impact of the borrowing programme would be known both to government and the central bank at the time the annual budget exercise is undertaken, an outcome which would facilitate closer orchestration of fiscal and monetary policies than at present.

9.45 Presently Treasury Bills bear a discount rate of 4.60 per cent per annum and as the bulk of these bills are held by the Reserve Bank interest payments accrue mostly to the Reserve Bank. As the discount rate is too low the general public is not interested in holding these bills, and only

banks and financial institutions presently purchase them and hold them for short periods before rediscounting them with the Reserve Bank. If the return on Treasury Bills is raised to such a level as will induce banks, financial institutions and the public in general to purchase Treasury Bills as an attractive avenue for deploying their temporarily surplus funds, the amount of Treasury Bills which will be rediscounted with the Reserve Bank would not be large as is the case at present. This would mean that Reserve Bank credit to government would be correspondingly lower, and more so if a secondary market in Treasury Bills also comes into existence. Such a rise in the discount rate on Treasury Bills can only be made applicable to future sales of Treasury Bills after Treasury Bills outstanding prior to the change in the discount rate are suitably funded.

9.46 An approach similar to the one outlined above for Treasury Bills could be adopted in the case of medium and long-term marketable securities of the government. Presently the market for these securities is a captive market. The continued issue of securities in volumes exceeding the capacity of even this captive market to absorb has resulted in recent years in the Reserve Bank subscribing to these securities with a consequent rise in Reserve Bank's credit to government and in reserve money. There is therefore, a clear need to offer marketable government securities to the public at attractive rates of interest. Such securities also constitute an ideal liquid asset in the economy and meet a genuine demand of the public, including institutions, for liquidity.

9.47 Apart from the problems of a rise in interest burden associated with the offer of higher coupon rates on marketable securities which is discussed later, offer of such higher rates should take into account the problem of erosion in the value of the portfolio of government securities held by banks and other institutions pursuant to the statutory requirements. A solution to this problem lies in stipulating that for the purposes of SLR the valuation of such securities be made on the basis of purchase price and not on market value. A major hurdle to the offer of higher coupon rates could then be eliminated. The Reserve Bank has very recently decided to change the basis of valuation of government securities held by banks with effect from March 29, 1985 so as to provide for valuation on the basis of cost price. The details of this change in valuation procedure are given in Chapter 13. Again, if securities could be issued at a discount on a limited experimental basis in view of the advantages of this method discussed earlier in connection with matters relating to public debt management, this problem would not arise since security prices would move up after being issued at a discount.

9.48 Offering a rate of return on Treasury Bills and dated securities that is attractive will enable the government to raise its required resources

without the excessive creation of reserve money that is inherent in the present system. Offering an attractive yield may initially mean a substantial upward revision of the discount rate on Treasury Bills from its present level.

9.49 Any serious consideration of an upward revision of coupon rates on medium and long-dated government securities will have to proceed on the basis that for all practical purposes the present SLR investment in government securities by banks would remain frozen as they will not have much inducement to sell these securities in the face of a capital loss. This block of securities will also not offer much scope for open market operations by the Reserve Bank. On the average, they presently yield a return of about 7 per cent which is less than the average cost of deposits to the banks. In the absence of an upward revision of coupon rates on government securities, banks will continue to suffer erosion in their profit levels resulting from the relatively low return on SLR assets as compared to the average cost incurred on deposits. In view of this, banks are likely to welcome an upward revision of coupon rates on government securities, even at the cost of having to hold their present mix of government securities till maturity, if the revision in the method of valuation of securities mentioned earlier accompanies the rise in coupon rates.

9.50 The public has currently the option of acquiring non-marketable Post Office Savings Certificates carrying interest at 12 per cent per annum backed by liberal fiscal incentives. The quantum of subscription to these savings schemes has been significant over the recent few years. This suggests that the non-institutional public might also be willing to subscribe to marketable, medium and long-term government securities if the coupon rates are suitably revised.

9.51 A restructuring of the yield pattern of government securities as well as Treasury Bills will result in substantially lowering the holding of these instruments by the Reserve Bank, thereby leading to a corresponding reduction in Reserve Bank's credit to government and hence in reserve money.

9.52 The coupon rates on long-dated securities were raised to 10.50 per cent per annum recently. The Government is, however, incurring an interest cost of 12 per cent per annum on two of the more popular small savings schemes covering certificates with a 6 year maturity. In addition to interest, benefits from fiscal concessions are available to certificate holders, if they are liable to tax. Unlike government securities these certificates are not marketable though encashment after three years with a corresponding specified lower interest payment is permitted. Government is thus incurring an effective cost of more than 12 per cent on these certificates.

9.53 Illustratively, assuming a level of gross market borrowing of the order of Rs. 4600 crores per year, enhancement in yield by an average of say 3 per cent per annum would increase the interest burden by Rs. 138 crores per year. It is difficult to estimate with precision how much of the new issues of government securities carrying the enhanced yield would readily be taken up by the public. Nonetheless it is safe to assume that the public will gradually increase its subscription to government securities carrying coupon rates (explicit or implicit) which are higher than the present levels by an average of about 3 per cent per annum particularly if the securities are available more or less throughout the year. Correspondingly, the subscription by the Reserve Bank will come down. In the case of Treasury Bills again there will be a similar additional interest burden which may amount to about Rs. 70 crores if Treasury Bills amounting to Rs. 1800 crores are issued at a higher discount rate of say 8.5 per cent per annum instead of the present discount rate of 4.6 per cent after funding the outstanding Treasury Bills so as to convert them into dated securities. The higher interest burden of about Rs. 208 crores a year as indicated in the above illustration could be deemed to be the annual cost to be incurred by the Central Government to prevent an undue rise in the Reserve Bank's credit to government and hence in reserve money so that achievement of agreed objectives in regard to control of money supply and maintenance of price stability is facilitated. Taking into account the market borrowings by the Central Government, State Governments, Electricity Boards, financial institutions and other government agencies, amounting to about Rs. 8300 crores in 1984-85, the additional interest burden may be of the order of Rs. 250 crores a year or so. The burden in subsequent years will, no doubt, go on increasing, if the yields are maintained at higher levels as mentioned, till such time as the favourable impact of this approach begins to be felt.

9.54 The higher coupon rates on government securities and higher discount rate on Treasury Bills would lead to higher absorption of government paper by the public resulting in lower monetisation of debt and lower increase in money supply than otherwise. For a given level of output, this would tend to dampen a rise in prices. The dampening of the rise in prices would very likely have a beneficial impact on government expenditures. Thus a part or even the whole of the additional interest burden might well be offset by saving in government expenditure. Initially interest costs will increase as successive tranches of government borrowing carry the higher coupon rates but as explained above the net impact on the Government Budget need not be large in the long run to the extent that relative price stability is achieved. Further, it should be stressed that the sale of government securities to the public is facilitated by price stability which would obviate the need to raise the yields on government securities

and Treasury Bills on a continuing basis and might even permit lowering of the yields depending on expectations in regard to the rate of inflation. In fact this is the scenario that is likely to emerge if reasonable price stability is maintained over a period of time. Indeed this should be the outcome if the monetary system is suitably restructured.

9.55 The beneficial impact on the economy of a reduction in Reserve Bank credit to government as illustrated above appears to be strong enough to support the major policy action which we have advocated of offering attractive rates of interest which will have the effect of increasing the participation of the public in the gilt-edged market and thereby reducing the monetisation of debt and consequent potential inflationary effects of government deficits.

9.56 Financing of government deficits increasingly by obtaining subscription from the public to Treasury Bills and government securities with resultant decrease in the monetisation of debt will have important implications for the functioning of banks, and for the credit flows to the non-government sector including public sector enterprises. This is because the importance of Reserve Bank credit to government as a source of change in reserve money will diminish and correspondingly the importance of Reserve Bank's claims on the banking system and the commercial sector will increase.

9.57 The increased holding of Treasury Bills and governm nt securities by the public would imply, other things being equal, a slower growth in bank deposits and correspondingly in bank credit reflecting the slower expansion of reserve money.

9.58 In order to maintain desired levels of bank credit to the non-government sector, the Reserve Bank would then have to provide additional reserves to the banking system through refinance facilities, and open market operations, apart from influencing the money multiplier by lowering the Cash Reserve Ratio. To some extent, therefore, additional reserve money has to be created on considerations relating to growth of output but the point to note is that maintenance of desired levels of bank credit to the non-government sector can be achieved through a less than compensating increase in reserve money as compared to the reduction in reserve money occasioned by the contraction in Reserve Bank credit to government, if the compensating reserve money expansion is in the form of RBI assistance to banks.

9.59 The implications of the policy measures suggested above for the operations of commercial banks need now to be examined.

9.60 The loss of buoyancy in bank deposits resulting from the above mentioned measures would imply a lower contribution by the banking system to government's resources through the acquisition of securities to meet SLR requirements. This by itself need not cause concern since the present channelling of monetary resources from the Reserve Bank to government, from government to the public, and from banks to government will be replaced by direct inter-action between the government and the public on the one hand, and between the Reserve Bank and the banks on the other. The latter arrangement has the considerable merit of subjecting government borrowings at least partly to the operation of economic forces, and of providing the Reserve Bank with the opportunity of not only providing reserve money to banks, but also of *withdrawing* it as circumstances warrant. The resulting greater dependence of banks on the Reserve Bank will facilitate conduct of monetary policy and permit both expansionary and contractionary policies to be pursued by the Reserve Bank as may be necessary without affecting government expenditures. The Reserve Bank would thus be in a better position to discharge its obligations in regard to control of money supply and maintenance of price stability.

9.61 To sum up, after restructuring on the above lines, the monetary system will exhibit the following features :

1. Government borrowings will be financed to a greater extent by the public than in the past.

2. Taking into account the growth in Reserve Bank credit to government as agreed to between the government and the Reserve Bank, the responsibility to control the overall growth of reserve money and money supply keeping the price stability objective in view will rest on the Reserve Bank. The Reserve Bank will be in a better position to discharge this responsibility as it will acquire greater control over the banking system and the rest of the economy to the extent that supply of reserve money to these sectors is amenable to greater variations than at present.

3. The control of inflationary pressures will be clearly perceived as a joint responsibility of the government and the Reserve Bank.

4. Regulation of money supply by the Reserve Bank could be undertaken in a meaningful manner as the Reserve Bank will have the necessary capacity to vary money supply growth rates at the margin by operating on reserve money, given the observed reasonable stability of the money multiplier.

5. A strong anti-inflationary stance is built into the monetary system as the expansionary effects of financing government deficits

substantially through creation of reserve money are avoided to a large extent.

6. The Reserve Bank will be better able to use interest rate policy as a monetary policy tool as a result of enhancement and restructuring of yields on gilt edged securities.

7. The economy will benefit by larger availability of short-term paper to meet its liquidity requirements.

8. The introduction of the proposed restructuring of the monetary system need not involve a long period of adjustment. The outstanding Treasury Bills have to be funded into special securities bearing a rate of interest equivalent to the present rate of discount and this can be done without difficulty. The new issues alone will then carry the revised discount rate. The dated securities which currently are mostly held by banks and institutions would need to be valued at purchase price instead of at market price to avoid the valuation loss if and when yields are revised from time to time. This change has become effective since March 29, 1985 in respect of valuation of SLR investments by banks. Related to these recommendations is the earlier recommendation regarding revision in the concept of budget deficit currently being used.

Interest Rate Policy

9.62 A notable feature of the Indian monetary system is the system of administered interest rates. The structure of interest rates which has evolved over the past several years has been oriented towards the twin goals of mobilising savings, and providing funds for capital formation to preferred sectors at concessional rates of interest.

9.63 Mobilisation of savings from both urban and rural sectors has been facilitated greatly by the rapid growth of banking over the past fifteen years. The phenomenal growth of fixed deposits with banks which has taken place over the years clearly indicates the popularity of this savings medium. It may be noted that even the maximum interest rate on fixed deposits offered by banks has provided a positive real rate of return to the depositors only during seven out of the past fourteen years. Further,the rapid growth in fixed deposits with banks has taken place although the rate of interest permitted on unsecured deposits with companies, and on debentures has been higher than the rates paid by banks on deposits of corresponding maturities. From this,one might infer that features like liquidity and security of bank deposits are given considerable weight in portfolio selection by savers in general. The preference of savers for bank deposits is also influenced by fiscal concessions which have been offered

in regard to interest earnings from bank deposits and Post Office savings media. These concessions which relate to certain ceiling levels of interest earnings on such deposits have helped to raise the level of the effective rate of return earned by tax payers on their deposits, to the extent covered by fiscal concessions, significantly above the nominal rate, as also above the effective rate of return available in respect of other savings like unsecured deposits with companies. Apart from liquidity and security, tax payers have found in bank deposits and small savings schemes an additional attractive feature by way of fiscal concessions. It needs to be stressed, however, that the small saver who benefits little from fiscal concessions has been exposed to negative real interest rates on his savings in the form of bank deposits, and therefore, the interest rate structure of bank deposits has not subserved the ends of social justice in this respect.

9.64 As regards interest rates on funds made available for investment, the administered structure of interest rates is far more complex. Market borrowings of government carry relatively low interest rates and this has perpetuated dependence on a captive market for government securities. Providing long term loans at concessional interest rates for different categories of projects and borrowers has been considered appropriate even in the industrial sector. Funds for investment in the agricultural sector as also loans to priority sector are made available by banks at concessional or relatively low interest rates. Generally ceilings are prescribed for the various interest rates and a whole structure of concessional rates has evolved incorporating decisions regarding the extent of concessions in interest rates to be offered to different groups of borrowers or on loans to projects in backward regions or on loans for specific purposes. As a result, for the economy as a whole the effective long term rate of interest is lower than the nominal interest ceilings for long term loans.

9.65 The complex nature of the administered interest rate structure has also resulted in reducing the scope for effecting counter-cyclical variations in interest rates. The links between the administered interest rates in the organised sector and the interest rates in the unorganised or informal sector are also not easily comprehended in the existing system of administered interest rates. Broadly speaking, the interest earnings of banks on their portfolio are lower than what they need to be on considerations relevant to their cost of operations and profitability. Interest rates applicable to a substantial portion of a bank's assets portfolio are either lower than or barely above their cost of funds. This is not a healthy situation.

9.66 The presence of substantial under-utilisation of capacity in several industries and incidence of sickness in industry points to the presence of demand constraints, inadequate infrastructural facilities, and other operational problems which need to be taken into account in consi-

dering additions to industrial capacity. In these circumstances, the prevailing system of offering concessions in long term interest rates is not likely to be appropriate. The implementation of projects with poor rates of return needs to be discouraged through a policy of maintaining real rates of interest at realistic levels by eliminating or reducing the element of concessionality in the interest rates charged on long term loans. This appears to have validity also in the case of concessional loans for modernisation. In the present Indian context there is reason to believe that an offer of higher real rates of return on savings would augment the pool of financial savings. Projects of sufficiently high rates of return would then have to be promoted to take advantage of the increased availability of financial savings. In doing so, if demand considerations do not support creation of viable additional capacity, in existing and familiar lines, entrepreneurs as well as government would be required to explore more carefully other available investment opportunities.

9.67 The substantial rise in the deposits held by non-resident Indians in recent years has also contributed to growth of deposits and hence in the ability of banks to lend. Credit control measures have aimed more at controlling the ability of banks to lend than restricting the demand for credit by raising interest rates. This is not to deny that interest rate changes have been used on occasions as a supplementary measure to regulate credit. Further, interest rates on government securities have been raised in the recent past, albeit in small measure, with resultant increase in the earnings of banks on their SLR investments.

9.68 The present structure of administered interest rates also blunts an important monetary policy instrument like interest rates. Interest rate policy, as an instrument to control aggregate credit levels, has limited scope under the prevailing system. The focus of credit policy has been to ensure that credit is not denied for productive purposes, that industrial credit is efficiently used through the observance of working capital norms, and that aggregate and sectoral credit flows are maintained at desired levels. There has not been much reliance on the interest rate instrument to achieve these policy objectives under the present administered interest rate system. The choice of instruments for the control of money and credit has, therefore, inevitably fallen on the Cash Reserve Ratio (more so in recent years which have witnessed strong inflationary pressures in the wake of the oil crisis, domestic supply bottlenecks and substantial fiscal deficits) and on credit ceilings.

9.69 We, therefore, believe that while the policy of relying on monetary budgeting and credit budgeting to achieve desired sectoral credit allocation should continue, there does appear to be a strong case for greater reliance on the interest rate instrument with a view to promoting the effec-

tive use of credit, and in short-term monetary management. Over the years quantitative controls on credit have increasingly borne the major burden of adjustment required under anti-inflationary policies and have in the process given rise to distortions in credit allocations at the micro-level. We believe that the quantitative controls can be more effective if they are supported by a suitable interest rate policy which incorporates a subsidiary yet crucial role for price rationing in the disbursement of credit. Further, while quantitative credit allocations reflect the imperative need to align bank credit with Plan priorities, the supportive role which we assign to the rate of interest is intended to facilitate a more effective use of such credit as is made available, given the presence of excess demand which is generally likely to prevail.

9.70 One consequence of the present system of administered interest rates is that it has largely eliminated price competition among banks who are expected to compete mainly in the field of customer service. While many banks have expressed their preference for this arrangement, a major issue that needs to be addressed relates to the extent to which some price competition among banks can be introduced considering the fact that about 90 per cent of the banking business is now in the hands of large banks in the public sector. Considering the general deterioration in customer service, a fact which is not denied by banks, the present arrangement of having an administered interest rate system and competition in terms of customer service has not served the customer well, nor the banks if their declining profitability is any guide. As our recommendations relating to revision of yields on government securities would, inter-alia, improve the profitability of banks, they should be in a better position to accept some degree of price competition in the interests of better credit management and as a spur to improvement in customer service. The beneficial impact of such competition would be reinforced if borrowers are given some freedom to choose their bankers.

9.71 The impact on profitability of banks and other financial institutions of an interest rate policy based on widespread use of concessional interest rates needs to be recognised. In the interests of promoting effective use of credit on the one hand as also operational efficiency of lending agencies on the other, it would appear that in the present structure of interest rates there is considerable scope for eliminating concessional interest rates or reducing the extent of concessionality, apart from reducing the number of categories for which different concessional rates are specified.

9.72 The pre-occupation with concessional interest rates has, unfortunately, deflected attention away from the much more potent instrument of social justice which takes the form of adequate and timely availability of

credit to the neglected sectors, particularly in the rural areas. We would, therefore, like to recommend that strengthening of the credit delivery system with a view to provide adequate and timely credit to target groups covered under priority sector lending should be given the highest priority and the motivation to do so should not be allowed to be reduced through any undue emphasis placed on grant of credit at concessional interest rates, since such an emphasis could well prove to be counter productive. As such only a very selective approach to the use of concessional interest rates seems to be warranted in contrast to the excessive reliance at present on concessional interest rates as a redistributive device.

9.73 We present our recommendations regarding restructuring of interest rates as a sequel to the above analysis, in the next chapter. At this stage, however, we would also like to comment on the effective use of credit which has an important bearing on the interest rate structure being recommended by us.

Effective Use of Credit

9.74 A system of administered interest rates and sectoral credit allocations have been considered to be necessary in the Indian context in order to allocate scarce resources according to Plan priorities. We are broadly in agreement with this view. Over the years, however, the administered interest rate system as also the sectoral allocation of credit have exhibited growing complexity. It is now increasingly recognised that the effectiveness of such a system of allocating scarce resources leaves much to be desired. A view is also held that the level of interest rates has been kept relatively low in real terms and this has encouraged relatively inefficient use of credit.

9.75 The high rates of monetary expansion, the rising capital-output ratio, and inflationary pressures during the past decade support the view that much stricter discipline in the use of credit needs to be enforced. The growing incidence of sickness in large, medium and small scale industries also suggests that concessional interest rates have probably encouraged investors to undertake projects with relatively low rates of return. In the case of government, the captive market for government securities resulting from the Statutory Liquidity Ratio requirement applicable to banks, and similar statutory provisions governing investment of funds of investment institutions like LIC etc. has facilitated the floating of debt at relatively low yields. The rigidities in revenue growth over the years combined with the efforts to step up public sector investment have led to a very substantial rise in net market borrowing. The net result of these developments has been that a substantial volume of credit is pre-empted by government at relatively low interest rates. The trends in government

expenditures and revenues indicate that this process of meeting a large proportion of expenditures through relatively cheap credit has continued for some years and is proving to be counter-productive, as the growth in public sector real investment has been considerably below planned levels due to inflation. In many years during the Seventies, the real interest rates on government securities were negative. In the case of Treasury Bills which have been carrying a discount rate of 4.6 per cent since 1974 the real discount rate has been negative in most years during the past decade. It is possible that availability of cheap credit has encouraged the financing of projects by government which would otherwise not have been considered financially viable. In any event, delays in the execution of large projects which should normally entail a heavy penalty by way of higher interest cost on borrowings do not do so in the case of public sector projects financed through cheap credit. The complex operations of government can be made more efficient if a device like raising the cost of borrowings is more effectively and widely used. Such a measure will serve to increase cost conciousness and more importantly focus attention on the additional cost involved in delayed implementation of projects, particularly very large projects with long gestation periods.

9.76 The above reasoning applies with equal force to the non-government sector, though the interest rate on long term loans to industrial projects has been considerably higher than the interest rate on government securities, if due allowance is made for the substantial investment in infrastructure undertaken by government. The quality of project preparation and the efficiency in project implementation and operation will certainly improve if the real cost of funds is not unduly low as a consequence of policies regarding grant of concessions in interest rates. Considering the under-utilisation of capacity in several industries, the utmost importance should be given to ensuring that creation of additional capacity is not induced by availability of funds at concessional interest rates, or fiscal incentives or by anticipation of protected markets.

9.77 In the case of working capital funds, the interest charged by banks to industrial borrowers has generally been considerably higher than the inflation rate. Nevertheless banks often face excessive demand for credit and have had limited success in enforcing adherence to norms on the part of industrial borrowers. While in some cases such demand for credit may emanate from anticipated speculative gains, in others, quite possibly the reason is that factors such as slackness of demand, transport bottlenecks, unavoidable bulk purchases, etc. have necessitated holding of larger inventories than the norms indicated by the banks. The growth and diversification of Indian industry over the years has brought in its wake a greater element of competition than was evident in earlier years wher

industrial units were set up mainly to facilitate import substitution. The keenness of competition has increased due to additional capacities having been created more because they had the support of an industrial licence than due to any realistic assessment of demand prospects. Within a limited domestic market this keen competition has resulted in uneconomic working of many industrial units leading in turn to heavy accumulation of inventories and reliance on bank credit to finance these inventories. The establishment of industrial units of uneconomic size due to the stipulations contained in the industrial licences has further aggravated the problem of achieving a viable level of operations. Under the influence of these factors, industrial units start on their road to sickness by being forced to accumulate heavy inventories in the face of slack demand. In these circumstances grant of additional credit would not only fail to prevent the onset of sickness in the industrial unit and consequent default in the payment of interest to the bank concerned but would contribute to inflationary pressures. The growing incidence of industrial sickness over the years has considerably distorted credit-output relationships. One needs to take serious note of the factors contributing to the emergence of such a situation. We would like to stress the importance of giving adequate attention to preventive measures in the absence of effective remedial measures once the borrower has implemented a project which was *ab initio* not viable. This calls for more careful appraisal of loan requests, particularly in regard to assessment of working capital needs of new projects than has been evident in the past. Even in the case of large public sector projects inadequate provision for meeting working capital requirements has partly contributed to their relatively low capacity utilisation and hence to higher capital-output ratios. One, however, cannot escape from the conclusion that a higher average real cost of long term loans for industrial projects should be achieved as compared to the cost that has prevailed in the past. This should be an essential element of any restructuring of interest rates aimed at discouraging the establishment of projects which are basically not viable and hence represent an inefficient use of scarce credit.

9.78 Facilitating recourse to bill finance is another desirable method of promoting effective use of credit. The promotion of a Bill Market has not had much success in the past reflecting the presence of several inhibiting factors in the monetary system. These are discussed later in the context of bank credit where we have made some concrete recommendations for removing the hurdles in the way of establishing an active market for bills.

9.79 The supervision of the end-use of credit by banks is rendered more difficult by the widespread use of cash credit as a means of providing credit for working capital. The feasibility of replacing the cash credit system by a system of loans and bill financing has been examined in the past by working groups appointed by the Reserve Bank of India. The traditional cash

credit system has, however, survived these enquiries. While not denying the several advantageous features of the cash credit system to the borrowers and to a lesser extent to banks, we recommend a steady reduction in its importance in bank lending and a resort to financing through loans and bills because of the adverse impact of the cash credit system on the Bill Market and the need to ensure better supervision by banks of the end-use of scarce credit, especially during periods of restrictive credit policy.

9.80 The objective of improving productivity in the industrial sector as also in the agricultural sector calls for a re-orientation of the present interest rate structure with a view to permit more efficient use of funds by the borrowers. We shall be dealing with this issue in the next chapter where we consider an overall restructuring of the interest rate system.

Monetary Targeting

9.81 The restructuring of the monetary system suggested by us in the foregoing paragraphs implies several major departures from the present structure. These may be summed up as follows:

1. The focus on price stability as a dominant objective of monetary policy will ensure that savers can look forward to a positive real rate of interest on their savings. It could also mean that the financial savings pool is enlarged. Similarly, borrowers will be discouraged from embarking on activities which would not be profitable in the absence of inflation and negative real interest rates on borrowings. The demand for credit would then be more truly aligned with the needs of genuine productive activities.

2. The issue of government securities at interest rates facilitating a much larger subscription by the public than at present will constitute probably the single most important departure from the past. The rates of interest offered by government on its short-term, medium-term and long-term borrowings will give the necessary flexibility to the interest rate structure in the economy as a whole. The greater availability of marketable government paper will give a fillip to the development of the money and capital markets and thus improve the overall efficiency in the use of loanable funds.

3. The cost of credit will not be held artificially low. It will be expected to reflect to a significant extent its scarcity value, at least for the major borrowing sectors. Concessional finance for specified user sectors will be extended only on the basis of a careful and continuing evaluation of the need for subsidising the cost of credit.

4. The accent will be on purposive use of credit. Use of credit even by preferred sectors is proposed to be restricted if its productive use is

not evident. This calls for further strengthening of the appraisal and monitoring machinery in banks and financial institutions. It also implies a more careful review of project proposals in the public sector.

5. The accent will be on providing ready access to credit to identified neglected and weaker sectors. Further, borrowers in such sectors can expect and should receive support from the lending agency by way of ancillary services, guidance and timely assistance so that the productive use of credit is enlarged in scope and strengthened through better lender-borrower inter-action.

6. Greater competition among lending and borrowing agencies will be encouraged within limits, both in the field of resource mobilisation and in deployment of resources. Such competition will be encouraged among banks not only in the areas of customer service as at present but also through providing some flexibility in the interest rate structure. The resulting strengthening and deepening of the money and capital markets will be subject to broad supervision by the monetary authority. At the present stage of development of the financial system greater competition is seen to provide an effective device to ensure improvement in efficiency across the board over the broad spectrum of lending and borrowing agencies which have already achieved a certain stature and stability in operations over the last decade.

7. Resource mobilisation for the Plans will include a larger direct contribution by the public than in the past. This will have the result of avoiding the inefficiencies of a captive market for government securities on the one hand, and improving the financial viability of the institutions which are presently channelling savings of the public to government at low rates of interest.

9.82 The implications to economic growth of the proposed restructuring of the monetary system as outlined above are likely to be most beneficial, as economic agents at the micro level will be using credit more productively in line with the real cost of credit. The implications for the objective of price stability are, however, more involved. The empirical evidence points to the influence which prices of agricultural products exert on the general price level. The vagaries of the monsoon,and administered prices can trigger inflationary processes which are not easily arrested. Experience with energy prices in the Seventies is a pointer to the kind of problems which periodic spurts in key prices create for policy makers attempting to maintain price stability. In the context of the above observed limitations of non-monetary policy options in the area of anti-

inflationary policy, particularly over the short and medium-term, and the rigidities which characterise the cost and price structure in the Indian economy preventing downward flexibility of prices. it becomes imperative to forge a tool of demand management at the aggregative level which is effective in the short and medium-term. In this context it is our view that the monetary authority has much to contribute to the success of demand management policies. The restructured monetary system which we have outlined provides the monetary authority with instruments which have the necessary strength, flexibility, and precision to accomplish the task of monetary management in the short and medium-term.

9.83 In implementing the suggested restructuring of the monetary system it will however, be necessary to carefully consider the problems of transition from the present system. This is so since the restructured system can be launched only through a one-time major adjustment in the rates of interest offered by government on its dated securities, as also in the rate of discount on Treasury Bills. In the initial stages it will be necessary for the monetary authority not only to monitor its repercussions on the rest of the monetary system and on the economy as a whole but also gear itself to guide and control the adjustment process so that the various components of the monetary system achieve an orderly transition under the new policy framework. While the basic philosophy of the restructured system lies in affording greater flexibility to monetary and related institutions at the micro level, the need to co-ordinate their activities in the interests of achieving national objectives of socio-economic policy remains, and the latter should be a major concern of the monetary authority. For satisfactorily discharging this responsibility, the monetary authority should develop at the aggregative level an acceptable overall pattern of regulation which it ought to provide in the interest of the successful operation of the monetary system.

9.84 It is in the above context that the need for the monetary authority to embark on monetary targeting in the more formal sense acquires importance. The monetary budgeting exercise presently undertaken, given the limitations of the present system, has provided the monetary authority with useful insights into the problems of formal monetary targeting. The greater control over the creation of reserve money envisaged in our restructured system provides meaning and substance to formal monetary targeting.

9.85 The successful formulation of monetary policy in terms of money stock as the target rests on three critical assumptions. First, the demand for money is amenable to prediction over the relevant time frame with reasonable accuracy in the context of relationships between money, output and prices which we examined earlier. Second, the money multiplier is

reasonably stable and predictable. Third, the monetary base or reserve money is subject to control by the monetary authority. While empirical investigations broadly support the validity of the first two assumptions in the Indian context, the restructured system envisaged above would contribute to the vastly greater validity of the third assumption as compared to the recent past. Formulation of monetary policy with M_3 as the monetary variable to be targeted thus becomes a feasible proposition in the restructured monetary system envisaged above.

9.86 Monetary targeting is an aggregative concept which lends clear direction to the monetary authority in the use of several monetary policy instruments at its disposal. The objectives of monetary policy enunciated earlier, and the responsibilities which the monetary authority has to shoulder in implementing the major policy initiatives arising from our recommendations in regard to restructuring of the monetary system, provide the framework within which the monetary targeting exercise has to be undertaken.

9.87 The manner in which the monetary target is to be derived is itself a matter for serious consideration. Several different approaches are indicated in the growing literature on the subject mostly based on the experience of monetary targeting in the industrialised countries. Most of these approaches are either too sophisticated or quite inappropriate in the Indian context. In particular, reference may be made to the constant money supply growth rule which stands at one extreme in the spectrum of approaches to target selection. In a developing country like India, where significant structural changes are sought to be achieved to facilitate the growth process the mechanical application of a constant money supply growth rule can have no place. Even annual variations in output triggered by climatic conditions which are a common feature in the Indian economy are strong enough to put any inflexible money supply growth rule to severe stress. Conversely, a rigid implementation of the growth rule in the face of supply shocks, structural rigidities and none-too-strong balance of payments position could lead to severe dislocation of the Indian economy and defeat the very purpose of employing monetary targeting as a tool of monetary policy.

9.88 The observed relationships between money, output and prices in India over the past two decades suggest a basis for determining the range of targets for monetary growth. The anticipated rise in real output could be taken as the starting point of the exercise. The observed income-elasticity of demand for money and the acceptable rate of increase in the price level during the year will be the other inputs. For example, if anticipated real output growth in the forthcoming year is 5.0 per cent, the income-elasticity of demand for broad money is 2.0 and the acceptable rise in

prices is 4 per cent (reflecting changes in relative prices necessary to attract resources to growth sectors) the target for monetary expansion may be set at 14 per cent for the year or a narrow range may be considered around 14 per cent. Having so derived the monetary target for the year, it is necessary to ensure that the monetary target is duly revised upwards or downwards during the year to accommodate revisions if any in the anticipated growth of real output, subject to the situation on the price front being not too much out of alignment with assumptions made earlier. This approach provides the necessary flexibility to the monetary targeting exercise and enhances its effectiveness as a monetary policy tool. What we have in view is not mechanistic monetary targeting un-influenced by the impact of developments in the real sector, but what we might characterise as monetary targeting with feedback which enables changes in the targets to be made in the light of emerging trends in output and prices. The setting of the monetary target has to be in the form of a range rather than a specific magnitude of monetary expansion, and should be altered during the relevant period in response to major developments in the real sector. The original target range, should be announced in advance and the circumstances under which modifications will be made should also be made clear; the modifications too should be announced in advance. We therefore, recommend that the Reserve Bank of India adopt monetary targeting as an important monetary policy tool, subject to the cautions sounded by us. This would bind the Reserve Bank and the Government of India in a common effort to achieve the desired rate of growth in money supply as in the Indian situation,control on monetary growth is impossible without the full support and understanding of the government.

Monetary Targeting Procedures

9.89 The level of the monetary target needs to be determined on the basis of desired growth in output, the tolerable level of the rate of increase in prices, and the expected income elasticity of demand for money. The rate of monetary expansion varies from year to year depending upon the anticipated rate of growth in real output, emerging trends in the economy like trends in agricultural output, industrial output, infrastructure, and prices. Nevertheless,it would be necessary also to have an aggregate monetary budget annually as also for the period covered by the Five Year Plans in order that, over the medium-term, reasonable co-ordination between the production and credit plans is achieved.

9.90 A credit budget for the banking sector is also to be prepared as a part of the exercises on the monetary budget. The objective of the credit budget is to determine the permissible level of bank credit to the commercial sector and a broad profile of the sectoral deployment of credit.

9.91 The actual implementation of the monetary budget will be guided by the current developments in the economy which should be regularly monitored. Credit policy measures should then restrain credit expansion or liberalise bank credit depending on whether excess liquidity and inflationary conditions emerge or economic activity tends to slow down. Given the importance of agriculture in the economy, this will entail issuing of guidelines to banks regarding the degree of expansion of food and non-food credit both at the start of the slack season (May–October) and at the start of the busy season (November–April).

9.92 A framework for working out the monetary projections on an annual basis is outlined in the following paragraphs. In the first instance the desired level of overall monetary expansion may be decided on the basis of the expected growth in real output and the price stability objective. The deposit component of the monetary expansion can then be determined on the basis of the behaviour of the currency-deposit ratio.

9.93 The main sources of monetary expansion or contraction are changes in banking sector's domestic credit, net foreign exchange assets and the net non-monetary liabilities. Bank credit to domestic sector consists of a) credit to government, extended by the Reserve Bank, commercial and co-operative banks and b) credit to commercial sector extended by the same institutions.

9.94 Reserve Bank credit to government may be projected on the basis of the trends in the level of Reserve Bank credit to State Governments by way of advances and the Reserve Bank's support to the Central Government's borrowing as agreed to between the Reserve Bank and the Central Government on the lines recommended by us earlier. This in itself rests on the acceptable increase in money supply. It is also assumed that the agreed limits will be adhered to. Commercial banks' credit to government is estimated on the basis of trends in their investments in government securities pursuant to Statutory Liquidity Ratio (SLR) requirements, given the deposit growth implicit in the desired monetary expansion. Co-operative banks' investments in government securities may be worked out on the basis of past trends.

9.95 Reserve Bank credit to commercial sector may be estimated on the basis of the allocation to various institutions from the statutory funds of RBI and other assistance. Similarly projected level of assistance to NABARD may be taken into account. The extent of RBI support will again rest on the acceptable increase in reserve money and money supply. The investments of commercial and co-operative banks in 'other approved securities' may be estimated according to SLR requirements and on the basis of the investments in government securities determined earlier.

9.96 The potential level of bank credit is then computed on the basis of the estimated growth in bank deposits and other resources of banks after allowing for pre-emptions in the form of Cash Reserve Ratio and SLR and increase in cash following the projected increase in business. These estimates of availability of bank credit could then be compared with the seasonal estimates of the demand for bank credit in order to establish the likely extent of recourse to RBI refinance by banks which in turn is cross-checked with the estimated expansion in the other components of reserve money.

9.97 An estimate of changes in net foreign exchange assets of the banking sector is also to be made based on past trends and likely developments influencing the balance of payments. Net non-monetary liabilities of RBI may be determined on the basis of past trends while that of other banks as a residual item given the projected M_3 level. The estimates of the sources of change in M_3 as obtained above are to be kept under constant review so that developments which are likely to come in the way of achieving the monetary target are noticed early and corrective action taken expeditiously through the use of the various monetary regulation instruments.

9.98 On the basis of the expected level of aggregate bank credit as derived in the foregoing exercise, the credit budget covering sectoral allocations of credit as may be decided in the light of Plan priorities is to be drawn up and discussed with the major banks. Modifications in the credit budget will be called for in the light of actual trends in monetary expansion as compared to their expected levels as may be revised in the course of the year in the light of output trends and the behaviour of prices.

9.99 It is evident from the foregoing discussion that the monetary projections are to be based both on behavioural relations for various components of money stock and exogenous factors like government budgetary operations and net foreign exchange assets. The crucial behavioural relations are the demand for money and public's preference for currency vis-a-vis deposits. It should be noted that implicit in the relationship is also the link between monetary expansion and reserve money expansion. The total expansion in reserve money which arises out of RBI actions and the change in foreign exchange assets along with changes in net non-monetary liabilities has to be consistent with the desired expansion in money supply. The cross-checking of estimates based on both demand factors and supply factors helps in formulating a monetary budget and a credit budget which are reasonably consistent with the expected growth in output and price stability.

9.100 A monetary planning model of the type described here would facilitate an analysis of the impact of alternative monetary policy measures and constitute an aid to formulation of monetary policy.

Chapter 10: THE LEVEL AND STRUCTURE OF INTEREST RATES

On the basis of the analysis presented in the previous chapter we are in a position to evolve guidelines for determining the structure of interest rates in the Indian context. Before we do so it would be useful to state briefly the major deficiencies in the prevailing system of administered interest rates. These are :

- The administered interest rate system has grown to be unduly complex and contains features which have reduced the ability of the system to promote the effective use of credit.
- The yields on Treasury Bills and government securities are at levels which have led to a considerable monetisation of public debt, leading to high levels of monetary expansion.
- The captive market for government securities, and the relatively low return to banks on their holdings of government securities have adversely affected the growth of the capital market on the one hand and profitability of banks on the other.
- Concessional rates of interest appear to have allowed projects of doubtful viability to be undertaken.
- The policy of insulating banks from price competition, and confining competition to customer service has not served to promote high standards of customer service.
- Quantitative credit controls have come under severe stress in the absence of support from any price rationing mechanism.
- The administered interest rate system has been found to be lacking the flexibility necessary for augmenting the pool of financial savings by effecting suitable changes in the deposit rates from time to time as the low profitability of banks mentioned earlier has made banks wary of increasing the average cost of deposits.

10.2 Any modification of the system of administered interest rates should aim at eliminating to a substantial extent, if not fully, the above-mentioned deficiencies. It would, however, be necessary to keep in view the following considerations while undertaking such an exercise.

10.3 First, it should be recognised that government is a major borrower and is under an obligation to pursue the objectives of planned socio-economic development of the country through successive Five Year Plans. It has taken on the responsibility of providing the substantial resources needed for developing infrastructure facilities. Similarly, it has

to allocate considerable resources for rural development partly in pursuance of the objective of social justice. Projects in these areas are known to have long gestation periods with high capital-output ratios, and resources to be used for the financing of such projects cannot be raised on normal commercial terms. Nevertheless the problem of ensuring an acceptable social cost-benefit outcome has to be faced in determining the appropriate parameters related to the financing of such expenditures.

10.4 Secondly, the monetary system must play its part in augmenting the pool of financial savings. If the rate of growth is to be stepped up in a climate of price stability, it is essential that adequate savings are mobilised by the financial system. Considering the important role of banks as financial intermediaries, the mobilisation of deposits by banks has a crucial role to play in the country's efforts to augment the pool of financial savings. The depositor needs to be assured of a reasonably high positive real rate of return on his savings so that he can be weaned away from deploying his savings in assets such as gold, real estate and commodities particularly when he expects inflationary conditions to prevail.

10.5 Thirdly, in the interest of social justice the monetary system should pay special attention to small savers, whose meagre savings come truly out of foregone 'essential' consumption, the low level of their consumption notwithstanding, unlike savings of the better-off sections of society. Saving schemes designed for small savers should clearly take cognizance of the fact that they are generally unable to take advantage of fiscal incentives in view of their low incomes and hence deserve a higher nominal return on their savings than other savers. The contribution of small savers to the savings pool could grow to significant amounts, considering their large numbers, if they are adequately compensated for their savings which, in the absence of social security arrangements, they surely need to accumulate over their working life.

10.6 Fourthly, quantitative controls on credit are necessary to achieve growth with stability according to Plan priorities. In a country engaged in planned economic development, however, the monetary authority is generally faced with the problem of regulating aggregate demand. Any attempt at demand management wholly based on quantitative controls on credit would soon lead to distortions and result in curbing growth impulses. In such a situation the supportive role of the price mechanism needs to be recognised as it would greatly facilitate the task of demand management, and also tend to ensure a more effective use of credit. Accordingly, a suitable interest rate policy should be evolved as a monetary management tool in addition to monetary targeting. The reliance on the price mechanism should be in addition to and not a substitute for, quantitative controls on credit flowing from Plan priorities and the compulsions of demand management.

10.7 Fifthly, it is to be recognised that inflation is a result of the interplay of several powerful forces in the economy, and accordingly there is no simple remedy for inflation. Nevertheless, we believe that monetary management has a major role to play in the control of inflation. This role need not be restricted to monetary targeting, though it can be one of the most potent weapons in the armoury of the monetary authority. Short-term interest rates could reinforce the anti-inflationary impact of monetary targeting if they are also used as a monetary management tool in fighting inflation.

10.8 Sixthly, it must be noted that concessional interest rates which come to be prescribed for target groups under priority sector lending reflect societal concerns which need to be respected. Any rationalisation of the array of concessional interest rates in the interest of administrative efficiency and as a result of an evaluation of the real costs of the lender must not, therefore, ignore relevant societal concerns.

10.9 Seventhly, considering the present stage of development of the Indian money market and capital market, determination of interest rates cannot be left entirely to market forces. A fair degree of regulation of interest rates is necessary so as to provide for an orderly mobilisation of financial savings for purposes of planned economic development as well as in the interests of viability of operations of banks of widely varying size in terms of deposits and advances and differing greatly in regard to the quality of their human resources.

10.10 Having mentioned the deficiencies of the present system of administered interest rates, and outlined the parameters which in our view should govern the restructuring of interest rates, we now proceed to develop guidelines for evolving a structure of interest rates which is consistent with the analytical framework developed by us in Chapter 9.

10.11 We shall first consider the discount rate on 91 days Treasury Bills. As mentioned earlier, since 1974 the discount rate has remained unchanged at 4.60 per cent per annum. Not surprisingly, the Reserve Bank of India presently holds about 90 per cent of the outstanding Treasury Bills, as other holders, mainly banks, rediscount the Treasury Bills with the Reserve Bank at the earliest opportunity in view of their low yield. In our view the Treasury Bills should be developed as an active monetary instrument and should constitute the ideal short-term paper in the money market. What comes in the way of such a development is its low yield. If its yield is substantively raised, not only institutional investors and banks but also other corporate bodies, local government agencies, and trusts who presently have no attractive outlet for short-term investment of their surplus funds could together constitute a sizeable market for Treasury Bills. It is difficult to determine, in the absence of recent relevant ex-

perience, what the discount rate on Treasury Bills should be in order to attract such short-term investments, and what magnitudes these investments would represent when the discount rate happens to be raised. The response of the market would largely depend on whether the discount rate is perceived by the money market as representing a positive return in real terms. Further, for reasons mentioned earlier, we are not in favour of a major financial instrument like the Treasury Bills carrying a rate of discount other than what is marginally positive in real terms, in order that a sound basis is provided for the further development of the money market, and more importantly to ensure that government borrowing by way of Treasury Bills does attract a cost in real terms which is marginally positive.

10.12 It should be noted that the Treasury Bill which is a short-term financial instrument so far as the money market is concerned, is indeed a long-term source of funds for the government as it rarely has budget surpluses leading to diminution in the volume of Treasury Bills outstanding. This constitutes an important aspect of Treasury Bills which needs to be taken into account in setting the discount rate on Treasury Bills, in addition to the likely response of the market which is no less an important consideration.

10.13 Initially, Treasury Bills carrying an attractive rate of discount may be absorbed by banks, financial institutions, corporate bodies and trusts in substantial amounts as they do not presently have suitable short-term paper in adequate volume to meet their liquidity requirements. The growth in the absorptive capacity of the money market in subsequent periods would essentially determine the extent of Treasury Bills that would additionally be absorbed by the money market. It is doubtful if this increase in absorptive capacity would be such as to enable the money market to absorb additional Treasury Bills each year in amounts of the order of Rs. 2,000 crores or more given the range of variation in the discount rate which budgetary considerations would permit. Accordingly, borrowing by way of Treasury Bills in relatively large amounts and on a sustained basis as has been the case in the past is not the mode of borrowing that can be successfully practised, without taking recourse to the Reserve Bank, in the context of the present state of development of the Indian money market. Nor should borrowing by way of Treasury Bills be construed as a convenient alternative to market loans of medium or long-term maturity. A short-term instrument cannot be used to finance essentially long-term requirements. The quantum of borrowing through the issue of Treasury Bills should truly reflect the unanticipated variation between revenues and expenditures which need not always be large.

10.14 Taking the above factors into account, we recommend that the discount rate on Treasury Bills of 91 days should provide an yield which is marginally positive in real terms. This means that the nominal rate of discount would have to be higher than the expected change in the price level. As we have mentioned elsewhere the outstanding Treasury Bills with a rate of discount of 4.60 per cent per annum need to be funded before new Treasury Bills are issued at revised rates of discount.

10.15 The yield structure of government securities of varying maturities could also be determined by following the approach outlined above in regard to Treasury Bills. Unlike Treasury Bills which are a short-term financial instrument, medium and long-dated government securities need to have yields which are in keeping with the expectations of the capital market in regard to the long-term movement of the price level. The response of the capital market to new issues of dated securities would depend on the real yields offered by them. We believe that real yields on government securities of 1 per cent to 3 per cent per annum depending on the maturity should meet the expectations of the capital market taking into consideration the likely volume of new issues of government securities in relation to the total size of the Indian capital market. Presently long-dated Central Government securities with coupon rates upto 10.50 per cent per annum have not enthused the capital market which has, however, given strong support to medium-dated debentures of public limited companies carrying a maximum yield of 15 per cent per annum. An upward revision of yields on government securities from current levels coupled with a shortening of the maturities can result in attracting funds from the capital market much above what the present captive market is able to provide. Initially it would be desirable to issue government securities of no more than 15 years' maturity beyond which, in a growing economy like India, it would be difficult for the capital market to envision the likely trend in the price level and the state of the economy. The period of 15 years also covers a period long enough to finance the bulk of the infrastructure projects with long gestation periods undertaken by government. Obviously the risk of non-payment in relation to government bonds is nil and therefore, the rate offered can be lower than the commercial rate for similar maturities.

10.16 In view of the above considerations we recommend that the yields on government securities with maturities not exceeding 15 years be so determined as to provide on an average over the entire spectrum of new issues an yield of 2 per cent per annum in real terms. Depending on the ratio of dated securities to Treasury Bills in the government's overall borrowing programme, the average real cost to government would then be less than 2 per cent per annum in real terms, as the recommended discount rate on Treasury Bills is expected to represent no more than a

marginal positive real cost to government. This statement, however,needs to be qualified, since the price expectations relevant to the discount rate on Treasury Bills are true for a very short term whereas those governing the response to the issues of dated securities span a relatively much longer period.

10.17 We would like to reiterate that the primary purpose of our recommending a revision in the yield structure of government securities is to eliminate the likelihood of any significant monetisation of debt, and consequent increase in Reserve Bank credit to government, beyond agreed limits. This purpose must be fully served by any realignment of yields on government securities that is undertaken, and here some amount of trial and error is probably unavoidable. Our recommendations will also lead to a significant narrowing of the spread between short-term and long-term rates of interest.

10.18 The revision of the yield structure of Central Government securities on the lines mentioned above would necessitate a corresponding revision in the yield structure of State Government securities, and other approved securities which are backed by guarantee of the Central Government or the State Governments in regard to repayment of principal and payment of interest.

10.19 Next in importance to the interest rates on government securities, the interest rates of particular relevance to the working of the monetary system are the lending and deposit rates of banks which we shall discuss in the following paragraphs.

10.20 We have earlier noted the need to introduce some element of price competition among banks. The 'controlled competition' which we have in view involves an 'administered spread' between the interest rate for bank deposits with a maturity of 5 years and above, to be determined by the Reserve Bank and the basic lending rate which would serve as a floor to the non-concessional lending rates of banks. This approach is designed to prevent competition among banks of unequal size, and also ensure a minimum spread between the deposit rates and lending rates which is broad enough to provide a basis for viable banking operations and yet narrow enough to prevent laxity in bank administration. We recognise the difficulty in arriving at a precise demarcation of the spread of the type we have described. Nevertheless, taking the present structure of interest rates and bank profitability as a guide, and also taking into account our recommendations in regard to the yield structure of government and other approved securities which are relevant in the context of the SLR investments of banks, we believe a 3 percentage point spread between the maximum rate on deposits and the basic (minimum) lending

rate of banks should provide an acceptable spread to the banks. In order to provide a suitable framework for evolving deposit rates for different maturities it is desirable that the Reserve Bank also determines the interest rate on bank deposits of one year maturity. The banks should be free to offer interest rates on deposits of varying maturities exceeding one year subject to these rates not exceeding the maximum interest rate to be fixed by the Reserve Bank for deposits with a maturity of 5 years or more; the recent policy announcement by the Reserve Bank provides them similar flexibility in regard to deposit rates for maturities of less than one year, subject to interest rates on deposits of less than one year maturity being no higher than that on deposits of one year maturity as determined by the Reserve Bank. The approach outlined above in regard to the 'administered spread' places considerable emphasis on the importance of offering savers a reasonable return on their long-term savings. On the basis of our earlier analysis of this issue, we recommend that the deposit rate to be offered by banks on deposits with a maturity of 5 years or more should be such as to offer the saver a minimum positive real return of 2 per cent per annum, and the deposit rate on deposits of one year maturity should be marginally positive in real terms; these deposit rates may be determined accordingly by the Reserve Bank.

10.21 Considering the public's preference for term deposits with a maturity of 5 years or more,we recommend that all banks may be required to accept such deposits. As regards other maturities, the banks should be free to choose their maturity pattern of deposits, so long as a bank adheres to a uniform pattern of deposit maturities at all its branches at any given time. We,however, recognise that a bank should similarly, be required to maintain an uniform interest rate structure at all its branches at any given time.

10.22 We also recommend that the interest on savings deposits with scheduled commercial banks may continue at the present level of 5 per cent per annum. With the growth in the number of bank branches the banking habit is spreading to hitherto unbanked areas and the interest on savings deposits represents an incentive to be offered to promote the banking habit, although these deposits are widely used for transactions purposes.

10.23 The absence of a ceiling rate on their loans and advances allows the banks freedom to vary the rates according to fluctuations in business conditions and their own cost of funds. This, of course, is a desirable feature which would promote better use of credit by borrowers, on the one hand and competition among banks on the other, the latter being circumscribed by the prescribed basic (minimum) lending rate. We do not believe

that such competition would in practice prove detrimental to the banks, as the borrowers may be expected to perceive the several advantages of maintaining a long-standing association with their bankers and not be swayed unduly by the offer of lower lending rates by competing banks. The presence of competition, however, would tend to make bankers more responsive to the genuine needs of the borrowers, more so if the borrowers are free to change their bankers after giving a reasonable period of notice. It would also prompt the borrowers to improve their credit standing and seek more favourable terms from their bankers on that ground.

10.24 On the above basis, banks will have the opportunity to adjust the cost and maturity structure of their deposits to suit their lending operations and thereby improve their profitability.

10.25 As regards bank lending to the priority sector, we have earlier commented on the need to rationalise the number of concessional rates. We would recommend no more than two concessional rates, one being equivalent to the basic (minimum) lending rate, and the other somewhat below this rate. We are unable to recommend any specific guideline for determining the lower of the two concessional rates as it involves several considerations which we have not been in a position to examine in sufficient detail. We would, however, recommend that the Reserve Bank should, in consultation with government, determine the concessional rate of interest which we have just referred to by specifying how much lower than the basic (minimum) lending rate it should be.

10.26 Pursuant to our recommendation that the credit delivery system in regard to priority sector lending should be strengthened, and timely and adequate credit should be made available to target groups, we further recommend that credit in excess of what is eligible for a concessional interest rate under specific lending schemes may be made available, at the basic (minimum) lending rate, if such additional credit can be justified on the basis of the viability of the productive activity being financed.

10.27 The above scheme of interest rates for bank lending reflects our concern for simplifying the complex system of administered interest rates and reducing the number of concessional interest rates to specific borrower categories. It also satisfies another important criterion inasmuch as bank lending rates are not likely to be lower than their average cost of raising funds except in the case of the lower of the two concessional rates applicable to priority sector lending. Further, as mentioned earlier, the element of price competition among banks facilitated by the absence of any ceiling rate on bank advances, and the opportunity they have of introducing a fair degree of price rationing to reinforce the impact of quantitative credit controls, should provide a suitable basis for ensuring an effective use of credit, and improving the efficiency of banks.

10.28 We have already made recommendations regarding the deposit rates but we now wish to consider some aspects of the deposit rates related to the objective of social justice which the monetary system needs to pursue.

10.29 At present interest rates on bank deposits are uniformly applicable to all depositors and no distinction is made between those who gain substantially by fiscal incentives and those whose low incomes prevent them from deriving any such benefit. The fiscal incentives made available to depositors appear to have been justified considering the phenomenal increase in the volume of fixed deposits over the years. These incentives need to be continued. There is, however, a strong justification, in our view, for providing the small saver a better deal than what he has got over the years for reasons we have mentioned earlier. We leave it to the imagination and innovative spirit of banks to devise suitable deposit schemes to achieve this objective.

10.30 Presently non-resident deposits are offered a higher than normal interest rate and banks are compensated through special provisions relating to CRR and SLR requirements. There is need for a continuing review of the factors leading to the grant of a special status to these non-resident deposits, by way of additional interest as also relaxations in the application of SLR and CRR requirements.

10.31 We now turn to interest rates of special significance to the money market. The inter-bank call money rate is currently subject to a ceiling of 10 per cent per annum. Our recommendations relating to a revision in the yield on Treasury Bills should provide banks with an acceptable short-term financial instrument and they need not depend entirely on the inter-bank call money market for meeting transient liquidity needs. Accordingly, the ceiling on the inter-bank call money rate would no longer serve any important purpose. We, therefore, recommend that this ceiling should be removed. While making this recommendation we should also refer to the need to broad-base the call money market to the extent practicable by permitting new institutional members, who are known to generate sizeable surplus funds now and again in the course of their normal operations, to participate in the call money market.

10.32 We have made recommendations elsewhere regarding the promotion of a bill market which taken in conjunction with our recommendations aimed at making Treasury Bills an active monetary instrument, should provide a sound basis for the development of an active money market in the country. We might mention here that we have made some recommendations in the following chapter regarding incentives by way of lower interest for bill finance, and disincentives by way of higher interest charges on cash credit facilities as compared to the basic (mini-

mum) lending rate referred to earlier which have a bearing on the development of an active money market.

10.33 We expect that at any given time the rate of discount on bills will be in alignment with other short-term rates particularly the call money rate and the discount rate on Treasury Bills. It would also reflect the impact of fluctuations in business activity. If industry and trade are to submit themselves to the discipline of bill financing to any significant extent, they would expect to derive in return, substantial benefits by way of lower overall cost of financing their working capital requirements. This would put some pressure on banks to keep their discount rates on bills at a level consistent with the level of business activity and the conditions in the money market. Further in order to provide the necessary incentive to banks to promote the use of bill financing, the Reserve Bank of India may allow banks some degree of freedom to exceed bill financing limits indicated in their credit budgets while monitoring these limits as a part of the credit budgeting exercise of the banks.

10.34 The banks have been providing loans to specified sectors at relatively low interest rates some of which are lower even than their cost of funds. We have already commented on this aspect of bank lending and have also suggested a framework within which such concessional loans may be made. Regional Rural Banks, however, are exclusively involved in lending to these specified sectors and hence have no means of their own, unlike other banks, to offset the loss incurred in making concessional loans at interest rates below their own cost of funds. They require special assistance in this regard in order that their operations are made viable. The possibility of the State Governments and the Central Government jointly bearing the cost of such special assistance could, therefore, be explored. Such an approach would not only help in improving the viability of Regional Rural Banks but also in providing some indication of the cost-benefit parameters of the programmes concerned.

10.35 To sum up, the level and structure of interest rates that we have recommended here explicitly takes into account the need to make a careful assessment of inflationary expectations in the economy while determining the nominal level of certain crucial interest rates. These interest rates are to be determined by the Reserve Bank in consultation with government as may be necessary. Within the broad framework of administered interest rates which we have recommended, banks will have considerable flexibility to compete among themselves and with the non-bank financial sector by varying their deposit rates and lending rates. The framework of administered rates which we have recommended is presented in Table 1.

Table 1 : The Level and Structure of Interest Rates

	Nominal Interest Rates
Treasury Bills (91 days)	: Expected short-term inflation rate *plus* a marginally positive real return
15 year dated Securities	: Expected long-term inflation rate *plus* a positive real rate of return of 3 per cent per annum
Bank deposits with a maturity of 5 years or more	: Expected long-term inflation rate *plus* a positive real rate of return of not less than 2 per cent per annum; the nominal rate to be determined by the Reserve Bank as the maximum rate payable on bank deposits
Basic (minimum) Lending Rate of banks	: Maximum nominal deposit rate fixed by the Reserve Bank *plus* 3 per cent per annum, banks being free to adopt higher lending rates.

10.36 The introduction of the recommended changes in the interest rate structure is expected to have a direct impact on the cost of credit in the economy as a whole and might initially involve upward revision of certain rates which currently are at low levels, particularly the yields on Treasury Bills and government securities. The higher cost of government borrowing arising from our recommendations should be seen as a factor contributing to better efficiency in government expenditures and greater accountability, as also to quantification of the implicit subsidies otherwise involved in low yields on government securities. The underlying justification for the revision in the yields on government securities, therefore, lies in the need to provide a visibility test by using higher yields as an instrumental variable rather than any attempt to equate government borrowings, with their well recognised externalities, with other borrowings. The objective should be to facilitate a better cost-benefit analysis of government expenditure programmes.

10.37 The revision of interest rates suggested by us together with the implementation of our other recommendations in regard to the restructuring of the monetary system, is designed to have the effect of dampening inflationary expectations in the economy and will hence permit a downward adjustment of all the administered nominal interest rates in succeeding periods as inflation rates both actual and expected come down.

Chapter 11 : BANK CREDIT

Under the Banking Regulation Act, the Reserve Bank of India enjoys wide powers to control advances by banks and exercise supervision over the functioning of the banking system, through the issue of directives to banks and otherwise. While selective credit controls relating to specific commodities prone to speculative activity, have been in force since as early as 1956, other measures to regulate credit have also been introduced by the Reserve Bank of India from time to time. These measures have been aimed at curbing inflationary pressures, promoting effective use of credit, preventing the larger borrowers from pre-empting the use of scarce credit and enlarging the spectrum of borrowers covered by bank credit, in the overall context of national priorities as enunciated over the years. We propose to examine in this chapter some of the more important of these regulatory measures from the point of view of their effectiveness and then consider ways in which their objectives could be better achieved.

11.2 Among the various regulatory measures in the field of bank credit, the Credit Authorisation Scheme (CAS) is one of the oldest and the most comprehensive. Under the Scheme, introduced in 1965 and still in force with modifications made since then, prior authorisation of the Reserve Bank of India is required before banks make credit available to borrowers in amounts exceeding the prescribed limits. The limit was fixed at Rs. 1 crore in 1965 and has since been raised to Rs. 4 crores and the exemptions made more restrictive. The Scheme covers both sanction of fresh credit facilities as also augmentation of existing facilities beyond the prescribed limit.

11.3 The CAS was initially viewed as a measure for preventing pre-emption of scarce credit resources by a few large borrowers. It was also seen as a means to achieve a closer alignment between the requirements of the Five Year Plans and the banks' lending activities. Additionally, in later years it came to be regarded as a convenient tool for imparting credit discipline to the borrowers and training in credit appraisal to the bankers. For the first few years after its introduction, the CAS meant no more than a scrutiny of proposed credit facilities with a view to ensure that large borrowers were not unduly favoured by the banks. In 1970 came the next stage when some uniformity was sought to be ensured in regard to the basic data relating to the credit proposals which were submitted by different banks to the Reserve Bank while seeking prior authorisation. The inflationary years of 1973 and 1974 prompted a closer look at the role of CAS as a credit regulatory measure. A scientific assessment of the

genuine credit needs of industry was sought to be made the basis of bank lending. The Study Group to Frame Guidelines for Follow-up of Bank Credit (more commonly known as the Tandon Committee) which was appointed by the RBI in 1974 came up with guidelines for assessing the credit requirements of industry and in addition proposed specific norms for inventory and receivables for 15 major industries. The guidelines related to the extent of financing to be undertaken by banks of the 'net working capital gap' defined as the difference between current assets, and current liabilities excluding the portion represented by short term borrowing from banks. These guidelines were incorporated in the CAS scrutiny of credit proposals.

11.4 A further tightening up of scrutiny of credit proposals coming under the purview of CAS was effected when most of the recommendations of the Working Group to Review the System of Cash Credit appointed by RBI (better known as the Chore Committee) were accepted by the Reserve Bank. The focus of the Chore Committee recommendations, based on the experience gained in the operation of the Tandon Committee guidelines and inventory norms, was on ensuring that the borrowers themselves financed their working capital requirements to a larger extent than in the past through internal resources and long-term funds.

11.5 The Chore Committee also emphasised the need to ensure better supervision and control over borrowers and recommended specific formats for the use of banks for obtaining details of quarterly operating data and forecasts of funds requirements from borrowers. It also stressed the importance of the banks undertaking regular annual reviews of credit limits based on detailed information provided by borrowers on the lines of the prescribed formats.

11.6 The Tandon Committee guidelines were applicable to all credit limits of Rs. 1 million or more. With the implementation of the Chore Committee recommendations by RBI, borrowers with credit limits of Rs. 5 million or more were additionally required to ensure that their current assets were financed to the extent of at least 25 per cent through long term funds which in effect meant maintenance of a minimum current ratio of 1.33 : 1 as compared to 1 : 1 for other borrowers under Method I of lending prescribed by the Tandon Committee which envisaged that 25 per cent of the working capital gap would be met by the borrower from non-bank sources of funds. The higher current ratio 1.33 : 1 corresponded to Method II of lending under the Tandon Committee guidelines which sought a gradual reduction in the dependence of borrowers on bank finance progressively through the application of Method I and then Method II of lending.

11.7 With the incorporation of the guidelines of the Tandon Committee and the Chore Committee in the CAS exercise, bank lending to industry came increasingly under the direct supervision of the Reserve Bank of India. In 1982 it was felt that an independent review of the Credit Authorisation Scheme which had been in operation for several years would be useful and accordingly the Reserve Bank of India appointed a Committee in November 1982 to review the working of the Credit Authorisation Scheme. The Committee which came to be referred to as the Marathe Committee submitted its report in July 1983. The starting point for the Marathe Committee's work was provided by the objectives of the Scheme as enlarged and re-defined in May 1978 and noted by that Committee as follows :

"a) To ensure that additional bank credit is in conformity with the approved purposes and priorities and that the bigger borrowers do not pre-empt scarce resources;

b) To enforce financial discipline on the larger borrowers, where necessary,on uniform principles;

c) Where a borrower is financed by more than one bank, to ensure that the customer's proposal is assessed in the light of the information available with all the banks; and

d) To bring about improvement in the techniques of credit appraisal by banks and their system of follow-up."

11.8 The Marathe Committee which was given wide terms of reference to examine the Credit Authorisation Scheme "from the point of view of its operational aspects" stressed that the "CAS is not to be looked upon as a mere regulatory measure which is confined to large borrowers. The basic purpose of CAS is to ensure orderly credit management and improve quality of bank lending so that all borrowings, whether large or small, are in conformity with the policies and priorities laid down by the Central Banking Authority. If the CAS scrutiny has to be limited to a certain segment of borrowers, it is only because of administrative limitations or convenience; and it should not imply that there are to be different criteria for lending to the borrowers above the cut-off point as compared to those who do not come within the purview of the Scheme". Further, the Committee was of the view that "It is not possible to avoid delays or improve quality of lending merely by concentrating on a single point. The borrowers have to do their bit by providing all the necessary and relevant information in time and in adequate detail. The long time taken in commercial banks in processing applications has to be reduced by suitable organisational changes. Similarly the time taken for scrutiny in the Reserve Bank also requires attention partly because it is the last stage of

the process, and because of earlier delays, it is found more irksome by the borrower. Improvement in the system as a whole has to be a conscious and continuous process in order to achieve the desired results". The major recommendation of the Marathe Committee was in the area of providing "an incentive for the borrowers to comply with all the requirements of the scheme including the information system and for the banks to improve the quality of credit appraisal". It recommended that "banks be allowed discretion to deploy credit in CAS cases which fulfil the following requirements, without RBI's prior authorisation :

i) The estimates/projections in regard to production, sales, chargeable current assets, other current assets, current liabilities (other than bank borrowings) and net working capital are reasonable in terms of past trends and norms (wherever specified), and assumptions regarding most likely trends during the future projected period.

ii) The classification of assets and liabilities as 'current' and 'non-current' is in conformity with the guidelines issued by RBI.

iii) The projected current ratio is not below 1.33:1 (except under exempted categories) and slip back in it, if any, from a higher level in the past to the projected level is on account of permissible activities indicated by RBI and not due to any diversion of funds outside the company.

iv) The borrower has been submitting quarterly operating statements for the past 6 months within the stipulated time and undertakes to do so in future also.

v) The borrower undertakes to submit his annual accounts promptly and the bank carries out the annual review of the facilities irrespective of the fact whether the borrower needs enhancement in credit facilities or not".

11.9 We are given to understand that the progress made in the adoption of the 'fast track' represented by the above recommendation of the Marathe Committee has been rather slow. This is not perhaps surprising, as the five eligibility conditions which have been laid down are quite comprehensive and further the sanction of credit facilities under the 'fast track' would still come under post-disbursal scrutiny of the RBI as in the case of sanction of credit facilities above Rs. 1 crore and below the cut-off point (now Rs. 4 crores for prior authorisation).

11.10 The Marathe Committee envisaged that the "need for a regulatory role for the Reserve Bank in respect of individual credit limits will diminish, if not disappear" if the banks are "able to evolve an operationa

culture which will be immune to unhealty pressures and which will have an in-built discipline in conforming to the broader parameters of policy laid down by the Central Banking Authority". It, however, cautioned that the "gradual diminution of the area in which prior authorisation by the Reserve Bank is needed before banks can disburse credit to individual parties should not, therefore, mean any erosion of its role".

11.11 The basic approach to regulation of credit to industry and trade adopted by the Reserve Bank over the years as briefly reviewed above may be broadly summed up as follows :

a) The basis of bank lending should be changed from security-based lending to lending based on funds flow;

b) Credit needs are to be assessed and met by banks based on industry-wise working capital norms, deviations from these norms beyond the prescribed tolerance limits being seen as evidence of improper credit use by the borrower requiring prompt rectification;

c) Reliance of borrowers on bank finance for financing working capital should be progressively reduced by insistence on maintenance of a current ratio of 1.33 : 1 by a growing segment of borrowers, the minimum acceptable ratio being 1 : 1;

d) Assessment of credit needs should be made on the basis of detailed information to be provided by borrowers on past performance and future projections of working capital needs and overall performance;

e) Final clearance by RBI of credit requests for amounts above the cut-off point under CAS was an essential element in the credit allocation system as banks were not always in a position to resist pressures from their larger clients, nor adequately equipped to undertake scrutiny of credit requests with the required degree of thoroughness;

f) Continuous efforts are to be made by the borrowers, banks and the Reserve Bank to improve the information system which is seen as the key to the success of the approach to credit allocation outlined above.

11.12 The borrowing community has over the years argued strongly against what it considers as the inflexibility and other inadequacies of the system of working capital financing adopted by the banks and the Reserve Bank of India. They have had the opportunity to present their views, in writing and during discussions, to the various committees and Study Groups appointed by the Reserve Bank of India to improve the methods

of bank lending to industry and trade. We have also received memoranda from the representatives of industry and trade, and had discussions with them, though not as extensively as other committees mentioned earlier. Their criticism of the credit appraisal system as it has evolved over the past two decades covers conceptual as well as procedural aspects of the system. Some of these criticisms voiced by them are pointed out below.

11.13 The norms evolved by the Tandon Committee for assessing working capital requirements of different industries have been criticised by borrowers on the ground that the norms do not provide for variations in inventory levels occasioned by the operation of several commercial factors, apart from locational factors and impact of unforeseen developments. For example, it is pointed out by them that in the case of industrial units located in areas with inadequate transport facilities inventory levels would reflect the longer lead time for supply of raw materials and despatch of finished goods. It has also been argued that the norms which may be valid under ideal conditions, do not distinguish between different units and variations in market conditions over time.

11.14 The levels of inventories in particular, and the level of total working capital requirements also depend on a host of extraneous factors in the economy over which the borrower, it is claimed, has no control. As indicated by representatives of the borrowers, these factors are inadequate and uncertain availability of power affecting production schedules, transport bottlenecks resulting from non-availability of railway wagons, non-availability of shipping space in the case of exports, changes in import policy, bottlenecks at the ports, bunching of imports, unanticipated changes in prices of raw materials and products made available by the public sector canalising agencies, government policies regarding the permitted level of stocks in specific industries, *ad hoc* allocations by canalising agencies of scarce raw materials, strikes and disturbed industrial relations affecting purchase of supplies or sales of finished goods, uncertainties associated with imposition of duties in the annual budget of the government, sudden changes in supply schedules prescribed by large public sector buyers, and so on. Under these circumstances borrowers point out that with the best of efforts they cannot project their working capital requirements even for one quarter, let alone for a year, with any degree of certainty. The management of these uncertainties itself consumes considerable time and effort, and sanction of credit based on rigid norms compounds the difficulties in managing the industrial unit. These problems get magnified in the case of smaller borrowers as they are less able to determine the terms of purchase or sale of goods and have a weaker financial structure as compared to the larger borrowers.

11.15 Specification of different norms for different stages of production and marketing, detailed instructions regarding classification of items as current liabilities and current assets, difficulties in assessing the validity of projections of working capital requirements based on uncertainties referred to above, all combine to make the credit appraisal process a difficult and time consuming exercise. Again it is stated that during the protracted time over which credit appraisal is being undertaken, unforeseen developments occur, prices and market situation change, monetary policy stance may change, resulting in a need to revise earlier projections which leads to another cycle of delays. This brings in a tendency to inflate the amount of credit sought in the original application for sanction of credit limits.

11.16 The main thrust of the Chore Committee recommendations was on bringing a larger segment of borrowers under the Method II of lending wherein the borrowers are required to contribute long term resources through their own funds and term loans to the extent of 25 per cent of total current assets as against Method I of lending where their contribution would be no more than 25 per cent of the difference between current assets, and current liabilities excluding bank borrowings. The borrowers are of the view that a rigid enforcement of this change would hurt industrial units. The resources at the disposal of the borrowers are limited and the application of Method II of lending should be gradual and based on the capacity of the units to augment their internal resources and term loans in a situation where the financial strength and industry characteristics of different borrowers vary widely, and the state of the capital market is also not uniform over the years. Borrowers have argued that they need funds for modernisation, expansion and diversification, and further many of them need to improve their capacity utilisation which calls for higher levels of working capital. While term lending financial institutions insist on greater contributions by the borrowers towards the cost of fixed investment in projects being financed by them, banks insist on higher contributions by borrowers for financing their working capital requirements. The borrowers feel that both these demands can hardly be met by them at the same time with their limited resources.

11.17 Bank credit sanctioned to borrowers takes the form of cash credit, loans and bill financing. While cash credit is the more favoured form of financing, banks specify separate limits for each type of assistance. The Chore Committee particularly stressed the need to insist on providing a part of the assistance by way of drawee bill limits. Separate limits are also specified for raw materials, finished products and receivables. The borrowers point out that this compartmentalisation hampers their ability to make the best use of the credit sanctioned to them and should therefore, be dispensed with, particularly since the components of working capital

undergo changes in the course of operations. The banks too have to spend considerable time and effort to monitor the use of bank credit in accordance with the various sub-limits specified by them. There is no doubt that the importance of timely availability of credit should be reflected in the credit appraisal process at all stages, and borrowers should facilitate quick decisions by promptly providing the information called for by banks.

11.18 Long term financial institutions have reason to be concerned that their relatively cheaper assistance is diverted to building up of working capital. At the same time banks are vigilant that borrowers do not appropriate larger than justified bank credit by diverting their own resources for expansion, modernisation or inter-corporate transactions. New companies find it difficult to have adequate margin for working capital as they are expected to conform to Method II of lending by banks from the time they start operations. Borrowers with a pronounced seasonal operation also face difficulties in meeting margin requirements during the peak season even when they are able to bring in their contribution during the year as a whole as required under Method II of lending. These factors appear to have complicated the financing of industrial operations.

11.19 Tax concessions available on additional fixed investment are attractive to industrial concerns who are naturally keen on availing of these concessions to the maximum extent possible, even if it means that they do not maintain margins stipulated by the bankers or margins for working capital at levels which they estimated while working out their project cost. Only when the borrowing concerns improve turnover of their capital, strengthen their equity base and obtain long term funds from the capital market will they be able to maintain adequate working capital margins on a regular basis. These options are open more to the larger companies who have a good past record of operations than to others, including new companies who are not well known in the capital market.

11.20 The overall credit limit for a borrower is determined on the basis of Tandon/Chore norms and is generally thought of as being based on cash flow projections. But this is not really the case. The approach outlined by the Tandon Committee rests on the use of balance sheet data and the norms, therefore, are derived on the basis of funds flow statements. As a result, the true cash requirements of a borrower are not properly discernible in the statements provided to the banker for assessment of credit limits. The extent of mis-match between credit limits and the credit requirements of the borrower would necessarily vary according to the scale of activity and seasonal factors. There is another aspect of credit limits which needs to be highlighted. The credit limit sanctioned to a borrower which is valid until it is reassessed, does not represent the extent of credit which the

borrower is free to avail of at any point in time. The utilisation of credit limit depends on the borrower having the necessary drawing power as computed from the stock statements submitted to the bank periodically. This means that the utilisation of credit limits is related, through the application of margin requirements, to the level of inventories, book debts and other eligible assets indicated in the stock statement available to the banker. This is so because the operating banker prefers to base his decision to lend on a legal document such as the stock statement rather than on funds flow or even a cash flow statement indicating credit requirements for a given future period generally of three to six months. Bank lending, therefore, essentially retains its security orientation despite the application of more sophisticated norms. Credit limits based on Tandon/Chore norms serve the purpose of providing a ceiling to the utilisation of credit based on drawing power. Thus the quantum of credit that can be utilised by a borrower at any given time is equal to the drawing power or the credit limit, whichever is lower. The present credit appraisal procedures do not prevent utilisation of credit facilities over and above what is justified on the basis of a cash flow analysis, so long as the drawing power is not exhausted. As the stock statements are available once a month or less frequently, and their submission can be delayed if it suits the borrower, the drawing power based on the latest available stock statement does not necessarily represent current credit requirements. Moreover, banks are often obliged to condone excess drawals when they are in the nature of *fait accompli*, these being detected with a lag when the stock statement for the relevant period is submitted.

11.21 One of the major causes of delay in sanctioning of credit limits by banks has been the failure of borrowers to submit the quarterly statements under the prescribed information system in time and in adequate detail. This is so even after the Chore Committee revised the formats relating to the information to be submitted which were introduced when the Tandon Committee recommendations were implemented. Even in the case of larger borrowers whose credit requests were subject to prior authorisation of the Reserve Bank of India, it was found that out of the 2321 applications processed by the Reserve Bank of India in 1982, further particulars were sought in as many as 702 cases. The Marathe Committee has noted that "while there has been considerable improvement in the commercial banks' appraisal systems, there are still wide variations as between banks and, sometimes, in the quality of proposals put up by the same bank. There are delays, often inordinate, in processing applications. Similarly, among the borrowers also many have introduced modern techniques for the management of working capital and finance. In several cases, tools like planning for working capital, cash budgeting and management information systems are increasingly being used. But here again

there is a considerable variation even amongst large borrowers; and the relatively smaller ones are still way behind. Altogether, while the working of the CAS has contributed a great deal and the banks as well as the borrowers have in many cases improved their systems, there is still a long way to go." Considering that the CAS has been in operation since 1965, these observations of the Marathe Committee are not encouraging. The reluctance of borrowers to comply with the requirements of the information system which constitutes a critical element for the success of the present system of credit appraisal is a real hurdle in the way of achieving the objectives of the credit appraisal system. The use of the funds flow approach based on balance sheet information in setting credit limits instead of a cash flow approach also makes monitoring of credit limits over the short term a difficult task.

11.22 The operation of the credit appraisal system since the introduction of the Tandon Committee norms has evidently succeeded in reducing the dependence of industrial borrowers on bank finance for meeting their working capital requirements. In the case of medium and large public limited companies in the manufacturing sector the ratio of bank finance to total current assets declined from 30.1 per cent in 1974-75 to 26.8 per cent in 1980-81, as revealed in the regular surveys of the finances of such companies undertaken by the Reserve Bank of India. In the case of large public limited companies in the manufacturing sector for which more recent survey results are available, it is seen that the ratio of bank finance to total current assets declined from 26.9 per cent in 1980-81 to 26.3 per cent in 1981-82 and further to 23.1 per cent in 1982-83.

11.23 The reduced reliance on bank finance has been made possible for the better established companies since 1980 by their greater access to the capital market facilitated by modifications in the official guidelines for the issue of convertible and non-convertible debentures. For the bulk of the lesser known industrial borrowers, however, this would not be the case. The latter have responded to stricter credit appraisal by banks by resorting to ways and means of increasing their current liabilities. The RBI survey referred to earlier indicates that in 1980-81 the ratio of current liabilities excluding bank borrowings to curent assets was 53.3 per cent for large public limited companies in the manufacturing sector. In comparison the ratio was 45.5 per cent for the medium and large public limited companies in 1980-81, having risen from 36.9 per cent in 1974-75. This is not a surprising finding and one can reasonably surmise that the effect of stricter credit appraisal was being passed on successively by the larger borrowers to the smaller and weaker borrowers, to a greater or lesser degree depending on prevailing economic conditions and the stance of monetary policy.

11.24 The transmission mechanism of the impact of stricter enforcement of working capital norms in financing the larger borrowers noted above is suggestive of a similar transmission of the burden of financing sales to government and semi-government agencies and public sector organisations who as a group are considered to be slow in releasing payments for supplies. The industrial units whose funds are locked up for long periods due to delayed payment by government agencies would perforce delay, in turn, their payments to their own suppliers, starting off a chain of events resulting in an extra burden of financing being placed on the small scale industries who generally are unable to obtain their supplies other than against cash payment. This problem has been recognised for quite some time now and not much progress has been made in evolving a suitable solution. Even the Tandon Committee came up against this problem while it was laying down norms for working capital financing. It noted that "like the public sector, Government purchase agencies are the biggest buyers in the country. Tardy payments by Government and public sector will only increase the level of receivables of industry and consequently the working capital requirements from banks for unproductive purposes. It would be useful if the Reserve Bank could initiate discussions on this matter. We also feel that Government should, pending streamlining its procedures, agree to pay interest on established delayed payments". Even after a period of almost ten years since the Tandon Committee made these remarks, it has been submitted to us that no improvement in the position was noticeable. The Tandon Committee itself did not provide any cushion for such delayed payments from government agencies in evolving working capital norms, even though their recommendations were meant to cover all borrowers with credit limits of Rs. 10 lakhs or more, thereby including a large number of small scale industrial units.

11.25 It is a matter of concern that the combined effect of stricter enforcement of credit norms in the case of the larger borrowers, and delayed payments by public sector and government agencies and other large units would be such as to place a heavy financial burden on the suppliers in the small scale sector, who are as a consequence driven to take recourse to credit from outside the organised sector at relatively higher cost as compared to bank finance. Remedial measures by way of earmarking credit limits for making payments to ancillaries and small scale industries have been thought of but are still an insignificant element in the present system of credit allocation and perhaps not easy to implement.

11.26 Like the small scale industries sector, another sector which finds itself at a considerable disadvantage in the present system of credit allocation, is the trade and distribution sector. As regards its role as a supplier of raw materials to the industrial sector it shares to some extent the problems faced by the small scale industries in regard to working capital

finance, though not all units in the trade sector are small or financially vulnerable, or weak in terms of bargaining power. The trade sector, in addition, has also to face a different kind of problem in regard to working capital finance.

11.27 Traditionally, the trade sector in India has been identified with trading in commodities of agricultural origin, the supplies of which were dependent very much on the monsoon and hence provided a convenient avenue for speculative activity. During the early years of planning, the trade sector also handled a considerable quantum of scarce, imported commodities which again provided fresh avenues for hoarding and profiteering. In this context the imposition of restrictions on bank finance to trade by way of selective credit controls in 1956 was a logical outcome. The trade sector continues to handle agricultural commodities and imported commodities as before but has undergone a significant transformation during the successive Plan periods.

11.28 The trade sector now includes large and powerful government agencies whose operations are guided by public interest and not merely commercial considerations. The introduction of the system of canalised items has removed from the private sector trade an important source of speculative activity, and at the same time provided the public sector corporations in the trade sector considerable power in the market to curb profiteering by the private sector trade. The Food Corporation of India which procures a significant proportion of the output of wheat, rice and other important foodgrains is today in a commanding position in the foodgrain sector which in the Fifties and Sixties suffered from inadequate domestic supplies, and provided private traders with plentiful opportunities for hoarding and profiteering to offset which various regulations regarding movement of foodgrains had to be imposed. Similarly, the State Trading Corporation and its subsidiaries, and the Minerals and Metals Trading Corporation handle import trade in commodities sensitive to speculative activity. Apart from the establishment of these corporations in the public sector, the strengthening of the Public Distribution System over the years and the establishment of other agencies like the Cotton Corporation of India, the Jute Corporation of India etc. to handle cash crops have brought into the trade sector a countervailing force to private sector trade. The large public sector units to which substantial supplies are made by the trade sector also are in a position to exert some influence on private sector trade.

11.29 The private trade sector is no longer confined to agricultural commodities and import and export trade. Over the years, as import substitution gained strength, the trade sector was required to switch from handling scarce imported items commanding a premium in the domestic

market to handling of products of domestic manufacture in a competitive market. The significant growth of small scale and cottage industries has provided the trade sector with a wide variety of goods with a regional or even national market. Here again several public sector agencies and co-operative marketing federations handle specific products and are in competition with private sector trade. Products of several small scale industries do not enjoy a ready market for a variety of reasons and marketing such products cannot by any means be considered to be an avenue for profiteering. The marketing of these goods in fact calls for considerable expertise and professionals with experience in marketing are increasingly setting up their own enterprises in the trade sector. These professionals with probably little capital but with marketing know-how are indeed deserving of working capital assistance from banks for setting up their marketing ventures.

11.30 The setting up of export houses in the corporate sector is another development in the trade sector which deserves encouragement and working capital finance from banks on par with industry. Similar is the case with marketing of the production of small units.

11.31 The low capacity utilisation in Indian industry over the years is probably due in some measure to poor marketing support for its products. The small scale industries, in particular, which have been receiving special attention from banks in view of their inclusion in the priority sector, face serious marketing problems and the entrepreneur is unable to attend to problems in diverse fields like production, purchase, finance and marketing. It has been found that sickness in small scale industries is often a result of financial stringency caused by poor marketing support to their products.

11.32 The trade and distribution sector has a vital role to play in the present stage of industrial development of the country. The emphasis on establishment of production facilities over the years was, no doubt, justified but the productive use of these facilities in diverse industries now requires a strong marketing and distribution effort. The growing sickness of industries, large and small, points towards the importance of maintaining a proper link between establishment of production facilities and their timely and profitable utilisation.

11.33 A beginning needs to be made in removing the misconception that trade is a low priority sector for bank finance as compared to industry in the present stage of economic development of the country.

11.34 We have so far discussed various aspects of the present system of working capital finance by banks in so far as they relate to the availability

and timing of bank credit to industry and trade, and the application of working capital norms for assessing working capital requirements. There is another aspect of working capital finance which has a bearing on the working of the monetary system. This relates to the mechanism of credit disbursement.Bank finance to industry and trade has traditionally been in the form of loans, cash credit and bill finance, of which the cash credit form of lending has been predominant. Bill finance has yet to take strong roots despite efforts by the Reserve Bank of India over the past two decades to popularise the use of bill finance. More recently working capital term loans are also being made by banks to a limited extent.

11.35 Bank credit to industry and trade has traditionally been made available to a significant extent in the form of cash credit, the degree of utilisation of the credit limits sanctioned varying from borrower to borrower at a given point in time and also varying in the aggregate over time. This is so because under the cash credit system the borrower is free to credit surplus funds to the cash credit account, and reduce his liability to the bank while retaining the freedom to increase such liability upto the credit limit sanctioned by withdrawing funds from the account subject to availability of drawing power. As all borrowers do not face peak requirements of funds at the same time the average utilisation of cash credit limits at a given point in time is much below the aggregate of cash credit limits sanctioned to the borrowers. Under the cash credit system, therefore, there is always an element of uncertainty as regards the impact of restrictive credit policy since borrowers can decide at short notice to utilise the sanctioned credit limits to the full extent in anticipation of a tightening of credit thereby negating the intended impact of the credit control measures.

11.36 The Chore Committee reviewed the working of the cash credit system in 1979 and its report contains a detailed account of the relative merits of financing working capital requirements through the cash credit system, loans and bill finance. It came to the conclusion that the prevailing practice of channelling credit through all three types of credit should be continued with certain modifications to eliminate the drawbacks of the cash credit system from the point of view of effective implementation of monetary policy. It also stressed the importance of increasing the share of bank credit granted in the form of loans and bill finance, particularly drawee bills.

11.37 The cash credit system, in our view, suffers from two serious drawbacks which have important implications for the working of the monetary system. Under the cash credit system the task of cash management is passed on by the borrower to the bank. All the surplus cash of the

borrower from day to day can be credited to the cash credit account thus reducing the outstanding balance in the account with concomitant benefits by way of lower interest liability. The bank, on the other hand, has to find ways and means of promptly utilising such funds which unexpectedly come into their possession in order not to suffer a loss of interest income.

11.38 Another related aspect of the cash credit system which has received somewhat less attention is the considerable benefit derived by the borrowers akin to interest income on their temporarily surplus funds. The surplus funds credited to the cash credit account reduce interest costs at the rate charged which now stands at 17.5 per cent per annum, a level of return on surplus funds not available to other sectors of the economy. If the working capital finance provided by banks was, say, entirely in the form of loans, the temporarily surplus funds would have to be invested in the money market where their return might be much lower than the normal lending rate of banks, apart from the fact that they would not be as risk free as using such funds to save interest charges by reducing the outstandings in the cash credit account. It is for this reason banks have to charge a higher rate of interest on cash credit limits than on loans. This, however, is not a satisfactory solution to the problem as the higher interest charges would apply to all borrowers equally, irrespective of their cash flow profiles, and thus may turn out to be inequitous. The efforts being made to restrict deviations from the sanctioned cash credit limit pursuant to the recommendations of the Chore Committee would not solve the problem, either, as the magnitude of effort involved on the part of banks cannot be justified by the results sought to be achieved. A possible solution lies in reducing the amount of bank credit sanctioned by way of cash credit limits.

11.39 In view of the features of the cash credit system discussed above, it is possible that the prevalence of the cash credit system has slowed down, if not thwarted, the development of a bill market and indeed minimised the relevance of a money market to the borrowing community. Further, the traditional practice of making or receiving inter-corporate advances has served to meet the requirements of companies which have a pronounced seasonality in their cash flows. We shall have occasion later to refer to this feature of the present system of lending by banks.

11.40 As mentioned earlier, the development of a bill market has not been a reality despite its well known advantages to lenders and borrowers alike and also despite the official policy actions aimed at promoting the use of bill finance. To refer first to procedural problems hindering the use of bill finance, the levy of stamp duty at varying levels by different State Governments, non-availability of stamp paper in required denominations as and when required, the need to affix stamps on each bill have been often referred to by banks and borrowers. We would like to emphasise the

urgency of removing these entirely avoidable impediments to the use of bill finance. The Reserve Bank of India and the Central Government should take the required initiative in this regard and evolve a satisfactory solution. Apart from these procedural difficulties, there is some reluctance to undertake the additional paper work involved in handling documents of title to goods. This reluctance could perhaps be overcome by providing the necessary financial incentive by way of lower financing charges as compared to those related to loans or cash credits. In our view the discount rate applicable to bills has not been sufficiently attractive to the borrowers to induce them to reduce their dependence on the cash credit system with its many other advantages noted earlier.

11.41 The principal obstacle to the growth of the bill market is of course, the reluctance of the larger buyers in the public and private sectors to accept the payment discipline involved in bill finance. Unfortunately even the public sector units who obtain their inventory requirements from a very large number of smaller suppliers, and have actively encouraged the development of ancillary industries, have been found to be averse to accepting bills drawn on them. We have earlier referred to the tardy payments made by the larger units in the public and private sectors to their suppliers. Delayed payments mean that the suppliers incur an additional cost by way of higher interest charges, apart from having to forgo the use of bank credit so tied up. We have not come across any estimates of bank credit tied up with delayed payments by government agencies and public and private sector units. If this represents a sizeable sum, as we suspect it does, restrictive credit policies will impinge only on the balance of bank credit and hence on that very portion of bank credit which is efficiently used in the normal course of business. This is because the borrower is in no position to expedite payments from governmental agencies, public sector units and large private sector units, especially during periods of credit stringency in order to reorient his business plans to the level of bank credit being made available. The earmarking of credit limits to the larger borrowers for making payments to ancillary and small scale industries is one of the solutions that is being tried but without very encouraging results. The problem is basically one of generating the necessary cash flow in the course of operations and poor financial results of even a few large public sector corporations are likely to upset the cash flow projections of their several large and small suppliers and set off a chain of events culminating in the weaker suppliers having to bear the bulk of the financial cost of delayed payments by the larger units which initiated the process. Under such circumstances it is easy to understand the reluctance of even larger units in the public sector or in the private sector to go in for bill finance limits in a big way. Nevertheless, the several well-known advantages of bill finance do justify a continuing and vigorous effort at promoting an

active bill market in the country, particularly in the present context where the Reserve Bank of India and the banking system are engaged in operating a complex system of credit allocation to industry and trade with the objective of ensuring that genuine productive activities do not suffer for want of credit and at the same time misuse of credit facilities made available does not take place. The Chore Committee has made several useful recommendations in regard to the encouragement of the bill system of financing, including the setting-up of a discount house for the "creation of a ready market for commercial bills, treasury bills and Government/ Government guaranteed securities by being ready to purchase from and sell to the banking system such securities." These recommendations need to be processed by the Reserve Bank of India and appropriate steps taken to achieve the goal of developing an active bill market in the country.

11.42 Having reviewed the working of the present system of bank lending to industry and trade we must now address ourselves to the task of evolving feasible approaches for effecting improvements in the system. Our review itself has thrown several pointers in this regard which now need to be further explored.

11.43 We have dwelt at length on the implications of delayed payments by government agencies and the public sector units on the whole system of credit flows in the industry and trade sector. These agencies have a dominating presence in the market. We do not believe, therefore, that any system of credit regulation can be devised which can successfully promote the achievement of the stated objective of economical use of bank credit for genuine productive purposes unless it is insulated from the impact of the fluctuating financial fortunes of the large public sector units and large private sector units on the one hand and the problem of tardy payments which has become endemic in the government machinery on the other. It is high time that due recognition is given in evolving credit policies to the fact that the public sector units along with government have achieved 'commanding heights' in the credit system no less than in other spheres of the economy. While the credit system should ensure that their genuine requirements of credit are met in adequate measure there is no justification for persisting with a system which transfers the financing charges to other sectors of the economy through the practice of non-payment of interest on delayed payments. Here our focus for the present is not on the quantum of credit made available to public sector agencies and large private sector units but on the need to ensure that they do not enjoy credit facilities, indirectly, at no cost. It is not within the powers of the present credit system to ensure that the public sector does pay for credit facilities indirectly availed of by it through delayed payments. The necessary and in our view also a feasible, solution lies in the government making it mandatory on the part of public sector and large private sector units to

include an interest payment clause in all their purchase contracts with their material suppliers for payments delayed beyond a specified period, such as 120 days, at a rate which is two percentage points higher than the basic minimum lending rate of the bank which has financed the supplier. Similar interest payments should also be provided for in all government purchase contracts for material supplies, and purchase contracts with small scale and ancillary industries. Such a provision would serve to promote more efficient materials management in the public sector units, and the interest payments involved also provide a measure of inefficiency and laxity in government payment practices which could serve as a basis for effecting improvements over time. Large units in the private sector too should naturally be required to make such a provision.

11.44 It is recognised that the financial fortunes of large industrial units in the public or the private sector are influenced by a host of extraneous factors not within their control. The proposal made above regarding payment of interest on delayed payments would not dislocate their operations in any significant way so long as the availability of credit justified by their needs is assured. This brings us to our second proposal, which relates to the availability of credit to such units.

11.45 Over the past several years, as we have noted earlier, the process of industrial development was accelerated through larger investment in fixed assets in diverse fields. A considerable degree of self reliance was achieved as a result. At the present stage, with the Seventh Five Year Plan emphasising better capacity utilisation and improvements in productivity, the focus has to be necessarily on better utilisation of existing capacity, achieving economies of scale to the extent possible, modernisation and technological upgradation to improve product quality, productivity improvements being the common outcome of all such measures. It is a moot point whether all the large public sector and private sector units have the necessary flexibility in their financial structure to undertake the tasks just outlined. These units need to build a strong financial structure so that they are able to transmit growth impulses to the rest of the economy on a sustained basis and not get bogged down from time to time with financial crises with their fall out on smaller borrowers.

11.46 In the preceding paragraphs we have identified two aspects of credit flows, one relating to the payment of interest on delayed payments to suppliers, and the other to the need for improving the financial capability of larger units to effect prompt payments. In our opinion, it is crucial to take into account these aspects of credit flows while attempting a restructuring of the present credit system in regard to which we now proceed to elucidate our approach.

11.47 The implementation of our proposal regarding payment of interest on delayed payments depends on an administrative decision by government. If government decides to implement this proposal, early implementation would be facilitated by concurrent action by banks under the guidance of the Reserve Bank of India in regard to providing necessary financial support in the initial stages of implementation of the proposal by the public sector units. The augmentation of working capital resources of the larger industrial units which we have referred to can only be implemented gradually over time and its impact on the rest of the credit system would accordingly be spread out over time. Keeping in view these factors it may be noted that the payment of interest on delayed payment, would improve the eventual cash flow of the suppliers and offer some immediate relief in regard to their problems of working capital management to the extent payments by government happen to be expedited. It is however only the success achieved by the larger units in augmenting their working capital funds required in order to effect prompt payments which would release working capital funds tied up in the supplies made to them by smaller units. Some relief to suppliers is called for in this regard till the larger units are in a position to strengthen their financial structure to a substantial extent and the impact of prompt payments by them is felt in the credit system. We, therefore, recommend that cash credit limits covering supplies to government by industrial units and other suppliers may be sanctioned by banks on a flexible basis. These facilities should be earmarked for the purpose, and all payments by government and public sector agencies for supplies financed by these facilities should be invariably credited to the earmarked cash credit account. This arrangement would also remove one serious dislocating feature in the present system of monitoring credit limits to industry and trade. It is interesting to note in this connection that, certain credit facilities relating to Government supply bills, supply bills drawn on semi-government bodies etc. were till recently exempted under the Credit Authorisation Scheme though this exemption has been recently withdrawn. What we are recommending here is a much wider application of the former approach and also more flexible assessment of the credit requests by borrowers in regard to sanction of the cash credit facilities on the basis indicated above.

11.48 Another major element of uncertainty in the assessment by banks of working capital requirements is the unforeseeable but sizeable draft on their financial resources which borrowers claim is due to a host of factors, which we have already noted, that are extraneous to the normal operations of the borrowers and often beyond their control in regard to timing or intensity of impact. Here again there is a need to assist the borrowers in managing the resulting financial crisis and to enable them to devote their time to solving other problems created by major events of the

type referred to. We, therefore, recommend that credit facilities needed to tide over these temporary crises should be expeditiously made available by earmarking a second cash credit facility for the purpose, on lines similar to those pertaining to the cash credit facility relating to supplies to government.

11.49 The grant of cash credit facilities earmarked for the two purposes mentioned above, would eliminate the major uncertainties relating to projections of working capital requirements. The level of the earmarked cash credit limits could be determined by the banks on the basis of their knowledge of the borrower's past operations and after providing for a margin for contingencies related to the borrower's planned level of operations. In the aggregate, for the credit system as a whole, fixing of limits for the earmarked cash credit facilities would only reduce avoidable dislocation of credit flows of the types discussed earlier where the smaller and weaker borrowers bear a disproportionate cost of such dislocation.

11.50 It can now be readily seen that the grant of cash credit facilities as recommended by us would facilitate better credit appraisal by banks since the normal working capital requirements of a borrower other than those covered by the cash credit facilities can be projected with greater certainty and the actual results are likely to exhibit lower variance from the projected levels than under the present system. From quarter to quarter, therefore, both the lending bank and the borrower would be in a position to improve their ability to project working capital requirements and also their ability to identify areas of weakness or bias in the projections, for remedial action by the borrower or the banker as the case may be.

11.51 The various credit limits sanctioned by the bank may be classified under Cash Credit I (covering supplies to government), Cash Credit II (covering special circumstances or contingencies) and Normal Working Capital limits covering the balance of the credit facilities. We recommend that the Normal Working Capital limits should be predominantly in the form of loans and bill finance limits, and should be reviewed periodically so that suitable revisions may be made including variations in the stipulated margins, as may be necessitated by seasonal variations in credit requirements, as also by the assessment of the quarterly projected requirements of bank credit requirements. The criticism against the use of Tandon Committee norms in the assessment of normal working capital requirements would have much less validity under the system of lending proposed by us than under the present system, and the response of the borrowers in regard to timely submission of their projection of working capital requirements could also be expected to improve. The Normal Working Capital limits may, therefore, be determined on the basis of Tandon/Chore norms as may be modified from time to time. We however

would like to caution that Normal Working Capital limits should be carefully assessed afresh keeping in view the limits to be sanctioned in regard to Cash Credit I and Cash Credit II, and should not be mechanically derived after subtracting Cash Credit I and Cash Credit II limits from the total limits as presently computed. Further the earmarking of Cash Credit I and Cash Credit II for the stated purposes should not be diluted in practice.

11.52 The sanction of credit limits predominantly in the form of loans and bill finance limits would serve to ensure that borrowers are unlikely to inflate their requirements either fearing delays in securing additional facilities to meet unforeseen requirements or due to laxity in the preparation of quarterly projection of working capital needs. This is because the borrower would be required to pay interest charges on the total amount of the loan sanctioned and also for the full period of the loan unlike in the case of cash credit facilities. The main element of flexibility in the use of the Normal Working Capital limit as envisaged by us lies in the use of the bill finance limit and as such the proposed arrangements are likely to give a fillip to the development of the bill market, particularly since temporarily surplus funds in the normal course of business will remain as a current account deposit with the bank unless better utilised, the option of bringing down outstandings in the cash credit account no longer being available to the borrower to any great extent unlike under the present system.

11.53 We recommend that interest charges for assistance under Cash Credit I should be at the basic (minimum) lending rate of the bank, and for Cash Credit II at the highest prevailing lending rate of the bank, the loan portion of Normal Working Capital limits bearing an interest charge in between the two and, a special lower rate being applicable to bill finance. The recommended gradation mainly reflects the risk differentials among the three segments of credit facilities. The recommended interest rates are presented in Table 1.

Table 1 : Proposed Interest Rates for Bank Credit to Industry and Trade

Cash Credit I	Basic (minimum) lending rate of the bank
Cash Credit II	Maximum prevailing lending rate of the bank
Normal Working Capital Limit	
– Loan Portion	Interest rate free to vary between basic (minimum) lending rate and the maximum prevailing lending rate of the bank
– Bill finance limits	2 percentage points below the basic (minimum) lending rate of the bank.
– Cash Credit Portion	Maximum prevailing lending rate of the bank.

11.54 The above proposal for a restructuring of the credit system has features flexible enough to accommodate the special requirements of small borrowers and others who do not face situations covered by credit limits in the form of Cash Credit I and Cash Credit II. The approach underlying the sanction of these earmarked cash credit limits could be extended to such borrowers by providing a separate cash credit limit, again earmarked for transactions with specific borrowers, as also for meeting sudden and relatively large, but temporary, credit requirements occasioned by unforeseen developments. Here again, in the sanction of limits under the earmarked cash credit account the banker will be guided by past experience and projected operations.

11.55 The institution of Cash Credit I to cover credit requirements arising out of supplies to government, semi-government and public sector units would provide valuable information regarding credit flows in the economy not presently available. For this reason, it is imperative that the Cash Credit I limits are not permitted to be used for meeting any other requirement for funds, including payment of taxes and duties to government. The unutilised portion of Cash Credit I should not be interpreted as representing any kind of access to credit other than for financing supplies to government and public sector agencies as envisaged in the grant of this facility. In order that the intended benefits of instituting Cash Credit I actually accrue to the borrower it is however necessary that banks are required to amend their current practice of disregarding bills receivable or book debts which are due for more than six months in the computation of drawing power. We recommend that bills receivable and book debts should be included in the computation of drawing power for Cash Credit I so long as they are not more than 12 months old. Similarly, institution of Cash Credit II limits should be guided by the magnitude of dislocation of cash flows occasioned by unforeseen events in relation to the normal cash flows of the borrower. The banks would be the best judge in this matter and they would have to exercise their judgement each time they sanction or revise limits under Cash Credit II.

11.56 The restructuring of the credit system on the above lines would confer tangible benefits on banks and borrowers alike, and at the same time promote the objectives of credit policy which in essence imply the effective and economical use of bank credit for productive purposes by all sections of borrowers, and minimising the spread effects of a dislocation of cash flows in a section of the borrowers on the rest of the credit system.

11.57 Under the system proposed by us the predominance of the cash credit system of lending will be absent except in the case of Cash Credit I and Cash Credit II meant for specific purposes only and we expect the need for the former will gradually diminish over time. As a result the

borrowers would be motivated in their own interest to give greater attention to drawing up realistic projections of normal working capital needs and to better cash management. In undertaking these tasks they could also draw upon the experience and expertise of their bankers. They would also find it to their advantage to make greater use of the bill market. The banks would approach the task of appraising credit requests with greater confidence in their judgement. This is likely because the institution of Cash Credit I and Cash Credit II limits would help in removing major uncertainties which otherwise would certainly upset their carefully drawn up projections of the genuine working capital needs of their borrowers. They would also find the task that much simpler, and vastly less time consuming than at present.

11.58 At the aggregate level, the lending system proposed by us would enable banks to monitor trends in outstandings under Cash Credit I, Cash Credit II and the Normal Working Capital limits and draw up their credit budgets on a more scientific basis, since outstandings under Normal Working Capital limits can now be expected, *a priori*, to be more closely correlated with the ebb and flow of economic activity. The variations between projected and actual Normal Working Capital limits are thus likely to be relatively of a smaller order as a result of segregation of uncertainties covered by Cash Credit I and Cash Credit II. Banks will, therefore, be in a better position to evaluate the efficiency of their credit appraisal machinery.

11.59 Similarly, at the macro level, credit planning by the Reserve Bank of India will be facilitated by additional information about the components of credit expansion which becomes available under the two new categories of lending proposed by us by way of Cash Credit I and Cash Credit II. This additional information should be valuable while determining the overall credit targets for the industry and trade sector.

11.60 The implications of the system of lending proposed by us for the functioning of the Credit Authorisation Scheme need to be spelt out. The task of improving the credit appraisal capabilities of banks which is being attempted under the CAS, becomes relatively less difficult, as the major uncertainties concerning assessment of future normal working capital needs are segregated, though not eliminated, under the proposed system of lending. Further, errors in judgement in fixing limits for Cash Credit I and Cash Credit II are unlikely to undermine any of the objectives of credit policy as they are earmarked for specific purposes and the utilisation of these limits is not, therefore, readily amenable to undesirable manipulations by the borrower. Working capital limits covered by CAS would continue to receive the close attention and scrutiny of the Reserve Bank of

India from various angles such as credit planning, likely overall industry performance and credit requirements, financial health of the large borrower, the implications of government policy in spheres related to the diverse activities which the large borrower is likely to be engaged in, views of all-India term lending institutions as may be deemed necessary, consortium lending aspects and so on. We recommended that the cut-off point fixed for prior authorisation under CAS should be reviewed at least every three years taking into account among other things the improvements that may be effected by banks themselves in the scrutiny and sanction of credit limits. We further recommend that for the present any request for increase in credit limit of the order of Rs. 5 crores or more per borrower or 10 per cent of the sanctioned credit limit, whichever is lower in a calendar year, should be covered by prior authorisation under CAS, all other credit limits being sanctioned by banks themselves. Depending on administrative considerations the Reserve Bank may determine the minimum absolute increase in credit limits during a calendar year which is exempted from the CAS provisions.

11.61 The community of borrowers in the industry and trade sector is already quite large and growing and as such pre-emption of large amounts of credit by a few borrowers is not likely to go unnoticed nor can banks facing continued pressure on their resources afford such luxuries. We, therefore, do not see much point in this aspect of credit either being given more than cursory attention in the CAS review, or constituting an argument for a broader coverage of CAS than what we have proposed.

11.62 Under the scheme of lending proposed by us we are not guided so much by the need to reduce the dependence of individual units on bank credit as by the imperative need to organise credit flows in the system in a manner conducive to its efficient and economic use and in a manner facilitating a more efficient management of their enterprises by the borrowers. Additional resources for expansion, diversification, modernisation, technological upgradation of industrial units and also for associated investments in working capital in industry and trade need to be mobilised by all concerned including the capital market, the banks, the term lending and investment institutions, as also by borrowers through improved productivity in their operations. Policies which only result in diversion of a given pool of resources by borrowers from one use to another depending on pressures from different lenders are not likely to be fruitful in the long run. The remedy lies in improving the productivity and efficiency of existing enterprises and institutions and creating conditions, through suitable economic policies, which are conducive to greater mobilisation of savings of the community and their deployment in desired channels.

Bank Credit to the Priority Sector

11.63 We shall now examine the salient features of bank lending to the priority sector which covers agriculture, small scale industry, setting up industrial estates, road and water transport operators, retail trade, small business, professional and self-employed persons, education, housing and consumption loans. The concept of priority sector was evolved in the late Sixties in order to focus attention on the need to ensure adequate credit facilities to certain neglected sectors of the economy particularly in the rural areas where banks had hardly made their presence felt. The involvement of banks in priority sector lending has grown considerably since the early Seventies along with the extension of the branch network of banks into the rural areas with special emphasis on opening branches in unbanked areas.

11.64 Policy guidelines issued in 1974 to public sector banks stipulated that by March 1979 they should extend credit to the priority sector to the extent of at least one-third of their total credit outstanding. This target was achieved in March 1981. In November 1978 private sector banks were formally covered under the priority sector guidelines. The target for priority sector lending to be achieved by March 1985 was raised in October 1980 to 40 per cent of aggregate bank advances. Banks were also expected to ensure that on an incremental basis 40 per cent of credit was extended to the priority sector. Within the overall target, the following sub-targets were also laid down:(a) 40 per cent of priority sector lending should be in favour of the agricultural sector, (b) 50 per cent of direct lending by commercial banks to agricultural and allied activities should be provided to the small and marginal farmers and agricultural labourers by 1983 and (c) 12.5 per cent of the total credit advanced to small scale industries should be reserved for artisans, village craftsmen and cottage industries. Further, banks were exhorted to ensure that finance provided to agriculture and allied activities should reach a level of at least 15 per cent of the total credit by March 1985 and 16 per cent of total credit by March 1987. It was also stipulated that advances to 'weaker' sections of the society which have been defined to cover small and marginal farmers, landless labourers, tenant farmers, share croppers, artisans, village and cottage industries, beneficiaries of Integrated Rural Development Programme, scheduled castes and scheduled tribes and beneficiaries of the Differential Rate of Interest programme should reach a level of 25 per cent of priority sector advances or 10 per cent of the total bank credit outstanding by March 1985. The trends in the credit portfolio of banks so far indicate that the banks are making concerted efforts to meet the prescribed sub-targets. The target in respect of small scale industries has already been surpassed.

11.65 The large volume of credit being extended to the priority sector over a wide geographic area, the considerable variety of activities being financed, the large number of schemes for specific target groups, the number of agencies involved in drawing up programmes to facilitate absorption of credit by the priority sector, the enormous increase in the number of loan accounts, are notable features of priority sector lending which have made the Indian banking experience in this regard quite unique.

11.66 Over the last decade banks have gained valuable experience in lending to sectors many of which were earlier quite beyond their realm of experience. The problems associated with improving the effectiveness of priority sector lending are principally in the area of organisational re-orientation and effective communication and monitoring. It should be stressed that the financial input provided by banks is only one of several inputs needed for the success of the priority sector programmes. A considerable amount of coordination among the developmental agencies at the district, block and even lower levels on the one hand and between these agencies and the banks on the other is a prerequisite for the efficient conduct of priority sector lending. This factor probably explains to a great extent the disparity in the results achieved under priority sector lending in different areas. In our view this aspect should receive the highest priority in devising a suitable framework for ensuring effectiveness of priority sector lending.

11.67 The conscious efforts of banks to reach targets and sub-targets has enabled them to achieve substantially the targets set for them. However, this achievement has brought in its wake a decline in the quality of their loan portfolio which probably was unavoidable considering the problems of coordination between developmental agencies and banks to which we have just referred. Remedial steps to improve the quality of lending however need to be taken on an urgent basis so that future progress is not adversely affected. Such measures would involve a more careful scrutiny of the viability of projects seeking assistance from banks, a more realistic assessment of the absorptive capacity of the borrowers in the area concerned, better training of bank personnel involved in priority sector lending and due regard to the assessment of the capabilities of the local agencies involved in providing relevant support to the borrower in implementing his project.

11.68 The extent of overdues has been attracting critical attention in the course of evaluation of the performance of banks in the area of priority sector lending. In earlier comments we have already referred to the factors influencing the effectivness of bank lending to the priority sector. The time has probably come to set maximum limits for overdues so that banks

put in their best efforts to stay within these limits which would also serve as a caution to them not to extend credit in areas which happen to show high overdues for all banks taken together. This approach would serve to elicit greater efforts from the local development agencies to improve the lending climate and the viability of priority sector projects. In this context we would like to suggest that relevant indices be developed to monitor the trends in overdues by activity and by area in respect of priority sector advances by the banking system as a whole. We shall be commenting further on this aspect of priority sector lending in the next chapter.

11.69 An important aspect of the growth of priority sector lending which should in our view, receive the utmost consideration in continuing the various programmes for priority sector development, is the fact that initial success was made possible by the ready identification of deserving borrowers. As the intensity of priority sector lending increases in an area, further growth in such lending without sacrificing lending criteria would become more difficult to achieve. It is necessary to guard against dilution of the concept of priority sector lending in such circumstances. In this context, however, it should also be noted that successful implementation of priority sector lending would, no doubt, lead to an increasing credit absorptive capacity of the area concerned as employment and incomes grow as a result of projects financed by priority sector lending. In order to achieve this end it is imperative that these projects taken together truly represent an integrated approach to the task of raising the level of incomes of the target groups. The increase in absorptive capacity mentioned here should be taken advantage of by banks and they should, accordingly, make suitable evaluation of the prospects for their normal lending operations in rural areas which reflect the impact of past developmental efforts. If this is done on a sustained basis the overall financial results of rural lending would improve over time and the banks would be in a better position to support developmental efforts in the priority sector in particular as also in the rural sector as a whole.

Chapter 12 : MONETARY REGULATION

Regulation of money supply has traditionally been regarded as the primary task of a central bank. The central banks in developed countries with open economies have undertaken this task with the traditional instruments of monetary policy which have their initial impact on interest rates and bank reserves. The conduct of monetary policy in these countries is influenced by the cyclical fluctuations in economic activity to which they are prone and it is generally agreed that the central bank should attempt to maintain a contra cyclical monetary policy stance to the extent possible depending on the degree of autonomy enjoyed by it in the economic policy framework of the country concerned. Even in recent years when the 1973 oil shock brought on strong and sustained inflationary pressures the central banks of developed countries have given considerable importance to the regulation of money supply as an antidote to inflation, an approach made easier by the theoretical underpinning provided by the monetarist approach to the problem of inflation over the last two decades. Formal adoption of monetary targeting has, therefore, gained greater acceptance in the central banks of the developed countries in recent years more particularly as a result of the success achieved by them in bringing down the inflation rate in the Eighties. To what extent this success reflected the impact of monetary targeting and not the contribution of other economic factors like the softening of worldwide oil prices is, however, still a matter of considerable debate among economists and policy makers.

12.2 In the conduct of monetary policy, central banks of developed countries have taken the rate of inflation and the rate of unemployment as important signposts. While traditionally the central banks had continually to assess the phase of the business cycle in which they were implementing monetary policies, in the recent decades the emphasis has been on evaluating the trade-offs between the rate of inflation and the rate of unemployment in implementing monetary policies. This has called for a careful evaluation of the impact of the changes in money supply effected through monetary targeting or otherwise, on the rate of inflation on the one hand and the level of economic activity and employment on the other.

12.3 The regulation of money supply in the above context is facilitated by the highly integrated money and capital markets of the developed

economies. At the same time the task is rendered difficult by high degree of integration of economic activity among these economies. The rather narrow range within which lie the growth rates of GNP of these mature economies facilitates the tasks of the central banks as does the excellent information system that supports their policy making exercises. The traditional instruments of monetary policy still serve their purpose quite well, though greater sophistication in their design and implementation has come about in the wake of rapid developments in the money and capital markets both domestic and international.

12.4 The tasks before the central bank of a developing country like India are multi-dimensional and stand somewhat in contrast to those of a central bank in a developed country which have a relatively short term focus and a well defined area of operations. As we have elaborated earlier, several objectives need to be pursued through monetary policy in a developing economy. Price stability, growth, equity and social justice, promoting and nurturing new monetary and financial institutions, close co-ordination with government in regard to implementation of Five Year Plans are all important objectives of the central bank in a developing country like India. These objectives are to be pursued in an economy characterised by duality in many important respects. Banks and financial institutions in the organised sector coexist with traditional institutions performing many similar functions in the unorganised sector. The organised sector itself is composed of large public sector institutions in the fields of industry, trade, transport and finance as also large, medium and small private sector organisations. There is a great diversity in the size of operations of different economic agents in these fields and it is an accepted objective of economic policy that the smaller units including cottage industries should be given due support so that they may survive and develop instead of being overwhelmed by the larger units. Development of rural areas where the bulk of the population, and most of the poor, live is entitled to a special place in economic and social priorities of the country. Great variations in the level of technology used in different segments of similar economic activities is another feature of a developing economy and India is no exception. As a consequence, financing of new enterprises based on modern technology has to be undertaken along with the financing of modernisation and technological upgradation of the older enterprises whose continued existence owes its justification largely to the need to preserve jobs. Conduct of monetary policy in the context of complex features of the economy of the type illustrated above poses a challenge to the central bank of the country.

12.5 Monetary policy in India has to contend also with significant variations in output from year to year caused by fluctuations in agricul-

tural output a substantial portion of which is exposed to the vagaries of the monsoon. A bad agricultural year means additional government expenditure on relief operations, reduced availability of agro-based raw materials for industry, lower export surpluses, pressure on the balance of payments resulting from unforeseen imports of essential commodities of agricultural origin to supplement reduced domestic supplies, and a strong upward pressure on prices, particularly on prices of articles of common consumption.

12.6 Timely availability of the required information and data would assist the central bank in formulating its policies. In this respect too a central bank in a developing country is likely to be considerably handicapped. In India there is a considerable wealth of data which the central bank can use but variations in coverage and timing as also the time lag involved erode their utility to some extent.

12.7 The difficulty in formulating and implementing monetary policies arises not merely from the complexities of the Indian economic system of the type mentioned here. It also arises from the trade-offs among various objectives which need to be evaluated on a continuing basis. As we have stressed earlier, monetary policy has to subserve the national economic and social objectives as enunciated from time to time in the Five Year Plans. The central bank cannot, on its own, decide to pursue one or more of its objectives vigorously at a given point of time to the neglect of the remaining objectives. This puts what we might refer to as an unusual constraint, on the monetary policy options, as commonly understood, that can be considered by a central bank in a given situation. If inflationary pressures warrant a check on growth of money supply, the need to maintain the flow of bank credit to the preferred sectors in the pursuit of social justice may dissuade the central bank from taking action on a scale warranted to achieve the desired deceleration in the growth of money supply. Regulating monetary expansion through the use of traditional instruments of monetary policy, in the Indian context, may not achieve by itself the desired allocation of credit to different productive sectors to meet the growth targets stipulated in the Five Year Plans, even allowing for the beneficial impact of introducing some element of price rationing on the lines suggested by us in Chapter 10. Credit planning and monitoring by the central bank, and credit budgeting by the larger public sector banks are therefore, tools which must be employed to ensure the desired allocation of credit, irrespective of the level of the target set for money supply in the light of macro economic considerations by making use of monetary targeting techniques. Again, the special features of credit extension to the preferred sectors and the complex institutional arrangements necessitated by the nature and magnitude of the task would call for major modifications in the operational and policy framework within which the tradi-

tional instruments of monetary policy are generally expected to be used. The resources channelled by the Reserve Bank to the co-operative banks, with a view to assist them in their agricultural lending operations, for example, are not comparable to the normal refinance facilities made available to the commercial banks. Further, the predominant share of cash credit facilities in the total credit facilities made available by banks to industry and trade, as also the impact on credit flows of delayed payments by government and public sector units, which have been referred to earlier in Chapter 11, impose constraints on the effectiveness of the traditional instruments of monetary policy aimed at regulating money supply, as also of credit allocation measures.

12.8 Successful implementation of policy measures aimed at developing an active money market would enlarge the scope for the use of traditional instruments of monetary policy and, therefore, such measures may also be deemed to represent a special instrument of monetary policy in developing economies.

12.9 In India the growth of reserve money over the years essentially represents the increase in Reserve Bank's claims on government. Legally, no limit is placed on the credit that can be obtained by government from the Reserve Bank. In such a context, the ability of the central bank to regulate money supply depends crucially on its ability to determine, in consultation with government, the optimum quantum of the projected increase in reserve money which should take the form of increased claims of the central bank on government. This exercise calls for expertise on the part of the central bank in assessing the desirable levels of reserve money creation to serve the needs of other sectors and in evaluating the compulsions faced by government in regard to incurring expenditures for implementing the Five Year Plans. The central bank will, therefore, have to develop tools and techniques necessary to make such assessments in a rational manner and thereby acquire the ability to advise government on the appropriate level of additional credit to government that it may reasonably expect the central bank to provide. Here again the traditional instruments of monetary policy do not provide the central bank with the means to regulate money supply unless they are supported by a suitable framework for co-ordination between the central bank and the government in regard to policies governing reserve money expansion.

12.10 From the above discussion it should be evident that in a developing economy the thrust of monetary policy cannot be restricted to regulation of money supply alone, and further, that the term 'instruments of monetary policy' as commonly understood does not adequately cover the range of tools and techniques which a central bank needs to employ to be able to pursue its various objectives. These objectives are to be pursued

simultaneously and as such the traditional instruments of monetary policy, as also other tools and techniques of the type that we have mentioned in the two preceding paragraphs need also to be employed simultaneously. It should, however, be stressed that regulation of money supply must necessarily remain the primary task to which the central bank in a developing economy should address itself while pursuing its various objectives. Our discussion in the foregoing paragraphs has highlighted the various related tasks of the central bank, since regulation of money supply would necessarily mean regulation of bank credit which in turn brings up questions related to its allocation. In performing its primary and related tasks the central bank needs, therefore, to employ a wide variety of instruments and not restrict itself to the traditional instruments of monetary policy like the Bank Rate, open market operations, variable reserve ratios, interest rate policy, rediscounting, refinancing, selective credit control, or moral suasion. We would, therefore, like to refer to the broad spectrum of tasks to be undertaken by a central bank in a developing economy like that of India as "monetary regulation". Accordingly, we will refer to the use by a central bank of the traditional instruments of monetary policy, as also other tools and techniques of the type we have discussed here, in the pursuit of its various tasks as 'monetary regulation measures' with a view to highlight the interconnections among the various instruments, and emphasise the constraints which apply to the use of any single instrument.

12.11 Monetary regulation, as defined by us, encompasses a much broader set of monetary policy actions by a central bank than that generally associated with the term 'regulation of money supply'. It, therefore, should also serve to focus attention on the inevitability of taking simultaneous policy action in vastly different areas to achieve given objectives, and hence the inherent complexities in devising a suitable mix of policy actions in a given situation, or over a period of time. The term 'monetary regulation' can also be expected to mirror more faithfully the presence of trade-offs in using different instruments of monetary regulation, as compared to traditional terms like 'regulation of money supply'. The broader connotation of the term 'monetary regulation' should provide greater scope for policy initiatives on the part of central banks in a wider field than generally perceived to be their domain. Such policy initiatives are very much needed in a developing economy, and should be aimed at removing the constraints on the effective use of the traditional instruments of monetary policy and at devising new instruments which facilitate the task of monetary regulation.

12.12 We now proceed to discuss the pursuit of its various objectives by the Reserve Bank through its instruments of monetary regulation.

Price Stability and Monetary Regulation

12.13 In earlier chapters we have already indicated the great importance that we attach to the pursuit of price stability by the Reserve Bank. We do not think it necessary to amplify on that theme here. We shall accordingly confine our discussion to the analysis of factors influencing prices, and the role of monetary regulation measures in achieving the objective of price stability.

12.14 A suitable index of changes in the general price level in India is provided by the index of wholesale prices (all commodities) with 1970-71 as the base year. The use of the consumer price index would have been more appropriate but the consumer price indices presently available cover specific sections of the working population and there is no comprehensive consumer price index which applies to the total population of the country. There is a reasonable correspondence between the behaviour of the wholesale price index and that of the consumer price index for industrial workers over a period of years even though of late there has been divergence on a year to year basis. Hence the use of the wholesale price index as a measure of changes in the general price level should not give rise to any mis-leading conclusions at the macro level.

12.15 In Chapter 7 we have briefly reviewed the trends in output and prices and commented on the rise in inflationary pressure since the early Seventies. The annual rise in the price level over the last fourteen years has not been uniformly high or of a sustained nature, the price rise being no more than three per cent in some years. Nevertheless, the virtual absence of downward flexibility in the price level, has been a matter of concern to the policy makers and has lent urgency to the task of achieving price stability.

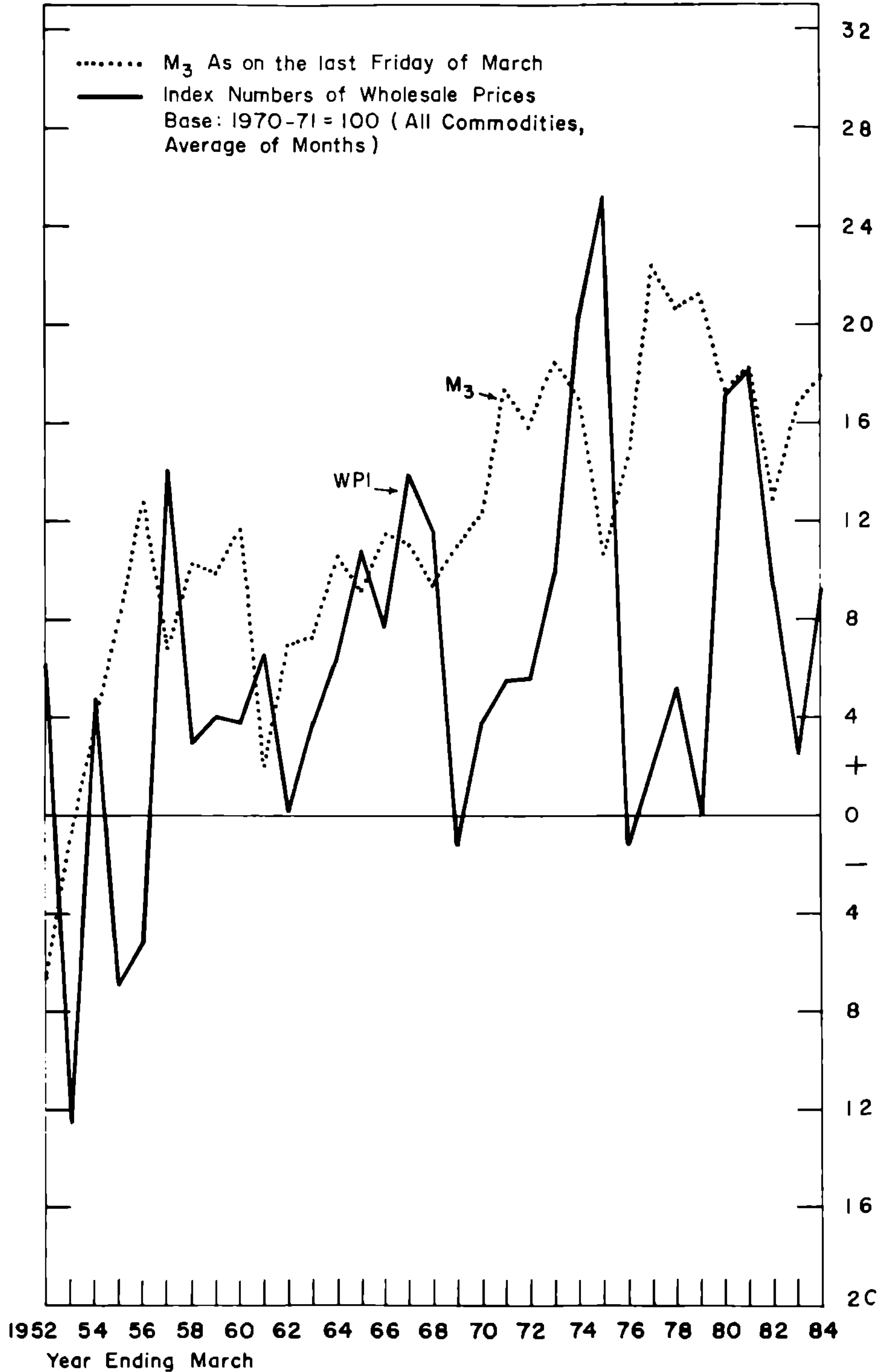
12.16 The wholesale price index stood at 315.3 in 1983-84 (average of months) as compared to 100 in the base year 1970-71. This represents an average annual increase of 9.5 per cent per annum. During these years, however, the annual rate of inflation exceeded 20 per cent in a year on two occassions. Further, in periods covering two successive years, the increase in the price level reached as high as 45.4 per cent during 1973-75, and 35.3 per cent during 1979-81. In contrast, a decline in the price level occurred only during 1975-76 in response to a strong package of anti-inflationary measures. The build-up of inflationary pressures indicated by such price behaviour poses serious problems for the monetary authority in devising its strategy for achieving price stability.

12.17 In view of the foregoing, the Reserve Bank should examine carefully both monetary and non-monetary factors influencing price behaviour before setting any target in regard to the extent of monetary expan-

sion, consistent with its price stability objective, as a part of its overall monetary regulation strategy.

12.18 The inflationary potential in the economy and the causes of the continuing rise in the price level have been the subject of several studies. The influence of periodical droughts affecting agricultural output and in the Indian context, also total output, on prices can be readily seen. The favourable impact of a bumper harvest on the general price level has been less evident. Further, price behaviour during years when output growth was moderate does not have any discernible pattern. A stable relationship between annual changes in output and annual changes in the price level taken in isolation cannot, therefore, be readily perceived. Similarly, changes in the price level exhibit little correlation with changes in money supply from year to year. As changes in money supply and output at the aggregate level have not by themselves provided a full explanation of the observed fluctuations in the price level, other factors influencing prices have also been the subject of considerable study. This is not to deny the major role of money supply and output in influencing prices over a period of time. Imported inflation, particularly since the oil price increase in 1973, impact of administered prices of manufactures, rise in procurement prices for foodgrains, pricing policies of public sector manufacturing and trading units, have been studied and brought into the framework of analysis of price behaviour. In empirical studies these factors are reflected in attempts made to study foodgrain prices, agricultural prices, prices of manufactured goods, prices of goods covered by administrative prices, non-agricultural prices as a whole, and so on, the general price level being arrived at as a weighted index of the components each of which is explained separately. The large number of factors to be considered, apart from output and money supply, in explaining the behaviour of prices makes the task of achieving reasonable price stability from year to year quite difficult and monetary regulation in this context also becomes a complex task.

12.19 While considering the influence of monetary expansion on the price level it should be noted that over the last several years there has been a gradual rise in the amount of money in circulation in real terms per unit of output. This phenomenon which we would like to refer to as 'monetary deepening' has important implications for monetary policy. The rise in the ratio of money supply in real terms to real output over the years needs, therefore, to be studied in all its aspects. This involves continuous research on the demand for money function and its behaviour over time even if the determinants of demand remain the same. The greater the extent of monetary deepening that occurs in the economy the lower will be the inflationary potential of a given increase in money supply.



MONEY AND PRICES
(ANNUAL VARIATIONS)
PER CENT
M_3 As on the last Friday of March
Index Numbers of Wholesale Prices Base: 1970-71 = 100 (All Commodities, Average of Months)
M_3
WPI
32
28
24
20
16
12
8
4
+
0
−
4
8
12
16
20
1952
54
56
58
60
62
64
66
68
70
72
74
76
78
80
82
84
Year Ending March

12.20 Policy measures which promote or retard monetary deepening will, therefore, have an influence on the assessment of the tolerable limits for expansion in money supply having regard to the objective of price stability. For example, we have referred earlier to the significant growth of fixed deposits with banks and the high proportion of time liabilities in total money supply. If the recommendations made by us in regard to interest rates and restructuring of the monetary system in other respects are implemented, there will be a need to examine their repercussions on the growth of fixed deposits with banks and monetary deepening. The extension of banking facilities increasingly to rural areas is another example of policy action whose implications for monetary deepening require to be studied. In the light of these remarks we would like to suggest that while changes in broad money (M_3) provide a reasonable measure of liquidity, a more appropriate indicator of liquidity build-up which takes into account the trends in monetary deepening should also be devised.

12.21 As the different sectors of the economy develop over the years the factors influencing price behaviour will no doubt undergo a change. The change will be reflected in the relevance or otherwise of explanatory variables over time as also in their changing intensity of impact on prices. In this context one should also take into account the behaviour of velocity of circulation of money and its implications for policies influencing the growth of money supply. Over the years the income velocity of M_3 has shown a steady decline. In 1950-51 the income velocity of M_3 was as high as 3.86. It came down to 3.12 in 1970-71 over a period of twenty years but exhibited a sharp decline over the next decade, its magnitude in 1980-81 being as low as 1.91 or less than one half of its level thirty years earlier. In 1983-84 the income velocity of M_3 was 1.86. This sharp drop in velocity since 1970-71 has probably been occasioned by the significant changes that have occurred in the structure of the monetary system, particularly the geographical spread of banking facilities, and the relatively slower growth till recently of other financial intermediaries. It would appear that the extent of fall in velocity as a result of further expansion of banking facilities would gradually grow less and less, while the trends in the growth of other financial intermediaries may tend to more than offset any such fall. For purpose of monetary regulation, it is important, therefore, to analyse the factors influencing change in velocity on a continuing basis, as structural changes in the economy are policy induced and could be an important source of change in velocity. The major anti-inflationary factor in the long run can only be growth in output achieved through increased productivity and better technology and through an economical and effective use of credit in the economy as a whole. Further, there remains the possibility of raising the rate of saving. The Reserve Bank and the government would no doubt, be making efforts to raise the saving rate, parti-

cularly financial saving through appropriate policies, with a view to raising the resources needed for the Five Year Plans in a non-inflationary manner.

12.22 The pursuit of the price stability objective by the Reserve Bank should take into account the various dimensions of the problem of containing inflationary pressures discussed in the preceding paragraphs. Emphasis should be placed on the long run aspects of the problem and on mounting a sustained effort to achieve and maintain price stability. Experience shows that in the Indian economy sudden spurts in prices resulting from the vagaries of the monsoon do occur at periodical intervals and might upset price expectations rendering the task of achieving price stability more difficult. Efforts should therefore, be made by government to impart a degree of downward flexibility to administered prices when warranted so that they do not impose an avoidable rigidity on prices and thereby accentuate the inflationary bias in the economy.

12.23 We recognise that price stability in the absolute sense is not a meaningful policy objective in the context of India's efforts at planned development aiming at a major structural transformation of a large and complex economy. The rate of increase in the price level during the period 1951-52 to 1964-65 was no more than 2.8 per cent on an annual average basis. Taking this order of price increase as a guide, we believe an average annual increase of no more than 4 per cent per annum in the wholesale price index should provide enough room for relative prices to change over the years as may be necessitated by changes in investment priorities and technological developments. This limit of 4 per cent per annum need not look so formidable if it is noted that over the nine years 1974-1975 to 1983-1984 the average increase in the wholesale price index for March was of the order of 7 per cent per annum, even after allowing for steep increases of more than 15 per cent during three out of the nine years. Again, the increase in the price level between March 1984 and March 1985 has been of the order of 5.7 per cent.

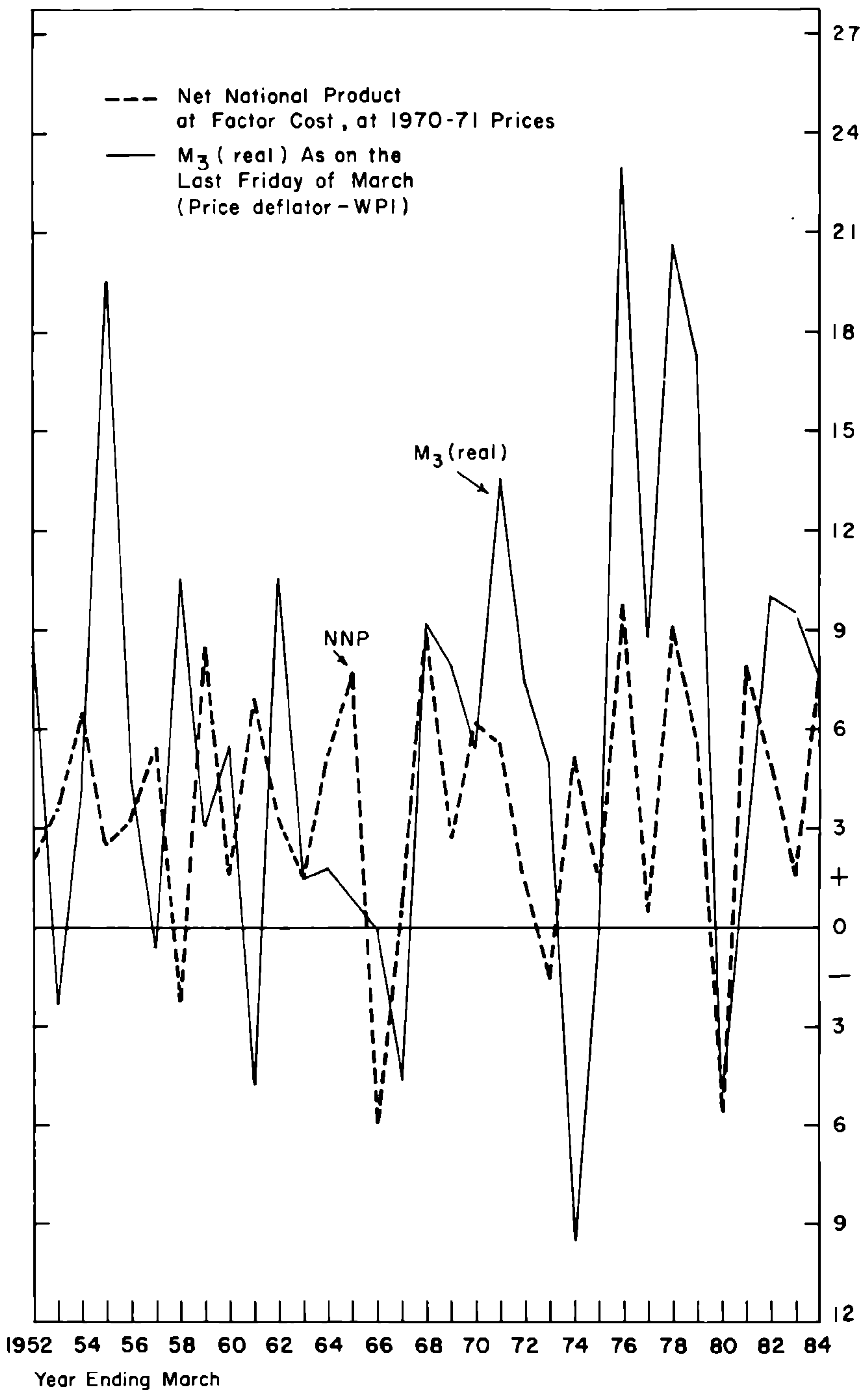
12.24 The favourable and unfavourable factors which interacted to produce a moderate single-digit inflation rate on an average annual basis over the past decade should be further analysed by the Reserve Bank and the government in the light of our comments made here in order to draw up an effective strategy for the achievement of price stability over the years to follow. Such an agreed strategy would lend immense strength and flexibility to monetary regulation measures designed to achieve not only price stability but also other major objectives of monetary policy which we will be discussing in the ensuing paragraphs.

Monetary Regulation and Growth in Output

12.25 Among the various factors influencing the determination of the tolerable degree of monetary expansion consistent with the objective of price stability probably the most important is the likely growth in output. Too much caution in setting the target of monetary expansion may help in the achievement of price stability in the short run but this approach will hurt growth in output and hence may lead to a build-up of inflationary pressures over the long run. Price stability is a desirable goal in itself but it is also expected to provide the necessary stimulus for mobilisation of savings and achievement of a sustained high rate of growth in output. As we have commented earlier a sustained high rate of growth in output is a strong anti-inflationary force and this must be recognised in devising suitable monetary regulation measures for promoting growth in output and achieving price stability. In this context we would also like to stress that a policy of maintaining relatively high rates of monetary expansion on the grounds that output growth in the long run will be raised is likely to be self-defeating if price stability is endangered in the short run. A very careful balance has, therefore, to be struck in arriving at a target for monetary expansion between the compulsions of accelerating the growth rate, and the need to achieve price stability.

12.26 We have earlier pointed out that the achievement of price stability depends on several factors in addition to the extent of monetary expansion. Similar is the case with the growth rate in output. The capital-output ratio, the rate of saving, investment priorities, efficiency of utilisation of existing capacity, technological factors, the investment climate and a host of other factors determine the growth path in the economy. The cost and availability of credit is also one of the factors influencing output growth.

12.27 The target for monetary expansion can be initially derived on the basis of targeted output growth and an assessment of other factors influencing prices, with the price stability objective in view. This exercise will simultaneously provide the extent of total expansion in credit by the banking sector which includes the Reserve Bank of India and all banks. The relevant magnitude for assessing the suitability of this initial target for credit expansion in regard to achieving the targeted growth in output is, however, the expansion in credit in real terms. Targeting higher levels of monetary expansion and hence of credit expansion in order to achieve higher growth rates, we would like to emphasise is no substitute for a careful evaluation of the extent of expansion in real credit that can be brought about by giving due weight to the objective of price stability as well as the growth objective.


M3 (REAL) AND OUTPUT
(ANNUAL VARIATIONS)
(PER CENT)
Net National Product at Factor Cost, at 1970-71 Prices
M3 (real) As on the Last Friday of March (Price deflator – WPI)
M3 (real)
NNP
27
24
21
18
15
12
9
6
3
+
0
–
3
6
9
12
1952
54
56
58
60
62
64
66
68
70
72
74
76
78
80
82
84
Year Ending March

12.28 The Five Year Plans indicate the target for the average annual rate of growth in output over the Plan period. While this provides a good starting point for assessing the associated growth in real credit over the Plan period, year to year estimates of credit requirements are hard to arrive at. This is so in view of the considerable fluctuations in the rate of growth in output from year to year mainly reflecting the impact of the vagaries of the monsoon on agricultural output. Even in the last decade, growth in output has fluctuated between a wide range of –6.4 per cent to +9.8 per cent. The initial estimate of the likely growth in credit, in nominal or real terms, is arrived at on the basis of the expected annual growth in output. This estimate requires to be reviewed in mid-year when the position regarding the likely growth in agricultural output becomes much clearer. At this time information would also become available in regard to the trends in industrial output. The mid-year review should also include an assessment of price behaviour during the first half of the year and its likely trend in the remaining part of the year. Without such a detailed mid-year review it would be difficult to implement monetary regulation measures consistent with the objectives of growth and price stability.

12.29 The revision in the credit target following the mid-year review would call for corresponding changes in the quantum and industry-wise deployment of credit. When the revision becomes necessary largely due to the fluctuations in agricultural output, the revised credit target should correspondingly be met mainly through variations in credit made available to those sectors or industries whose activities are significantly influenced by the fluctuations in agricultural output. This needs to be stressed since an across the board tightening of credit under those conditions as a sequel to a downward revision of the credit target is not likely to achieve the optimum allocation of credit among different sectors, since some of them may not be affected by the fall in agricultural output which necessitated the downward revision in the credit target. In indicating sectoral targets for credit allocation, therefore, it would appear to be necessary to make a separate allocation for agro-based industries and trade as a whole which would move up or down with agricultural output. In making this comment we are aware that the presence of several linkages between different sectors of industry and trade make it difficult to assess precisely the impact of deviations from the expected rate of growth in agricultural output on any one sector or industry. Nevertheless the 'first round' effects are likely to be the more significant and these could be covered by indicating separately credit allocation for agro-based industries.

12.30 The two major factors influencing the setting of the annual targets for monetary expansion and the associated level of credit are price behaviour and fluctuations in output, and the implications of these for

monetary regulation have been discussed in the preceding paragraphs. We now turn our attention to the question of allocation of credit.

12.31 Various recommendations have been made by us earlier in regard to market borrowing by government with a view to achieve lower monetisation of debt as also to reduce the volatility in the level of Reserve Bank credit to government. If these recommendations are implemented, it would be possible for the Reserve Bank and government to agree, at the beginning of each year, on the extent of credit to government which should be met by the Reserve Bank and the banks. Credit to government could be provided to the agreed extent by the Reserve Bank by absorbing Treasury Bills while avoiding as far as possible subscription to government securities. The banks would provide credit through their SLR investments. We would recommend, in this connection, a more flexible use of the SLR instrument as compared to the past. So long as the return available on these securities are not kept unduly low periodical upward or downward variations in SLR would not upset profit planning in banks, barring drastic variations. Occasions when such drastic variations in SLR are called for in order to meet large shortfalls in the offtake of government securities by the public need not arise often, if at all they do. As banks are now required to maintain their SLR investments during a fortnight at levels computed in relation to the applicable base of demand and time liabilities a fortnight earlier, modest changes in SLR as envisaged by us need not imply any sudden and burdensome imposition on the banks. A flexible use of the SLR stipulation involving upward or downward revisions which we have recommended here is aimed at providing government the agreed amount of credit while at the same time shifting credit between government and non-government sectors as warranted by the situation.

12.32 In the Indian context, one can readily concede that there may arise occasions when credit requirements of government significantly exceed targeted limits. These additional credit requirements will have to be met to the extent possible within the overall credit targets, any excess requirements being met by the Reserve Bank. In such circumstances, the Reserve Bank should undertake a major review of its monetary regulation measures so as to minimise the spill-over effects of a revision in the monetary and credit targets on the extent of monetary expansion to be targeted in the following year. If additional requirements of government are not large, the mid-year review of monetary expansion and credit targets, which we have suggested earlier, should take these also into account.

12.33 We have made several recommendations for achieving a smooth flow of bank credit to industry and trade, and for the development of an

active money market. A consequence of implementing these recommendations will be that short term fluctuations in the resource position of banks will be significantly reduced and hence the ability of the banking system to meet its credit obligations as targeted is likely to be enhanced. This will have a major beneficial impact on the implementation of their credit budget by the larger banks and facilitate the achievement of the aggregate credit targets set by the Reserve Bank. In the light of the foregoing, it would appear that the Reserve Bank need not follow a restrictive discretionary refinance policy. Here again we would like to emphasise the need to increase the flexibility of the Reserve Bank in influencing the resource position of banks. The various recommendations we have made earlier seek to remove the uncertainty associated with the extent of increase in reserve money which has had its repercussions on the working of all the important monetary regulation measures. As this uncertainty gets reduced it would be possible to achieve greater flexibility in the use of instruments like the CRR, refinance facilities, the SLR stipulation as also open market operations. Such flexibility is essential if credit requirements of government, industry, trade and the priority sector are to be met according to plan.

12.34 Looking ahead, we note that under the Seventh Five Year Plan emphasis is being placed on increased productivity. In the industrial sector this would mean higher utilisation of capacity which will call for higher levels of bank credit. In the allocation of credit, therefore, the thrust of monetary regulation should be on ensuring that adequate and timely credit is made available to industrial units who are in a position to implement their plans for achieving and maintaining higher levels of capacity utilisation as also plans for expansion of capacity. As the fortunes of different industries vary over time, it is important that industries facing a favourable market should be encouraged to make the best of the available opportunities for growth by providing them reasonable assurance in regard to availability of adequate credit. Under the scheme of credit targeting which we have discussed in the preceding paragraphs, this would call for adjustments by banks in regard to credit extended to other industries facing market or other constraints which hamper their growth. These adjustments would be justified on the grounds of effective use of credit which we stressed in Chapter 9. Increase in bank credit extended to industrial units should be justified by growth in sales and not merely reflect growth in inventories. As cutbacks in labour force when industrial units are faced with market or financial constraints are not feasible in the Indian context, certain amount of bank credit tends to get locked up in such units. The maintenance of a minimum level of production to keep the labour force employed and minimise losses leads to unavoidable additions to inventories. The situation could well deteriorate and such industrial units

may become sick units in which case bank credit would get tied up in these units and cease to be productive. As no easy or ready solution exists to the problem of industrial sickness, the effectiveness of bank credit as a whole in supporting growth can only be increased if fast growing industries are adequately supported by bank credit. Probably more attention should be given by banks to bank credit sought per unit of sales revenue in deciding credit requirements of their borrowers than appears to be the case at present.

12.35 The more successful industrial units have been able to mobilise considerable resources directly from the public by issuing convertible and non-convertible debentures, as also through company deposits. These resources have been utilised for meeting working capital requirements and for fixed investment. While this trend, more noticeable during the Eighties, is to be welcomed, the implications for the effective use of bank credit are to be carefully examined. The funds obtained by the successful companies from the public would have the effect of releasing bank credit which otherwise they would be utilising to meet their working capital requirements. The manner of deployment of bank credit so released would influence the effectiveness of bank credit. If it is used to support other industrial units having successful operations, its effectiveness need not diminish. If on the other hand it is used to finance, at the margin, the working capital requirements of concerns with poor operating performance, there will be an erosion in the effectiveness of bank credit. As groups of successful industrial units successively achieve a reduction in their dependence on bank credit by tapping funds from the public, the deployment of bank credit released thereby becomes an important aspect of monetary regulation. In evolving credit targets for industry and trade, therefore, it becomes necessary to assess the extent to which successful and well-established industiral units are able to mobilise resources directly from the public to meet their working capital requirements. It will then also be necessary to devise suitable lending criteria to ensure that targeted bank credit to industry and trade is channelled in adequate measure to those borrowers who have efficient and successful record of operations but not well-established enough to tap the capital market. The use of bank credit for propping up weak and inefficient units should be reduced. As banks cannot afford to keep their funds idle they would always be seeking new borrowers as their resources increase. Monetary regulation measures should be such as to encourage the banks to maintain a loan portfolio of high quality in regard to their loans to industry and trade.

12.36 Even a moderate improvement in the performance of large public sector organisations in important sectors like power, coal and steel

would entail a not inconsiderable increase in the quantum of bank credit to be made available to them. Such an improvement would, in all probability, also result in a notable increase in the capacity utilisation in the industrial sector as a whole as a result of better availability of infrastructure facilities and intermediate products apart from a higher level of demand from these public sector organisations. The credit allocation measures should be flexible enough to accommodate the additional demand for credit arising out of such welcome developments in the industrial sector so that their impetus to growth is not reduced through inadequate or delayed response from the banking system.

12.37 The small scale industries contribute a significant share of total industrial output and presently enjoy preferential treatment in regard to grant of bank credit. These units, however, are generally short of internal resources and also do not have the benefit of trade credit or other non-bank external finance from the money market or capital market to any significant extent. Their dependence on bank credit is as a consequence quite high. This feature of small scale industries is not likely to show any marked improvement. The availability of bank credit enables the small scale industries to continue their operations but imposes on them a burden in terms of interest cost which they find onerous in view of the high share of bank credit in their working funds and the generally delayed payments for their supplies which we have discussed at length in the previous chapter. Their dependence on bank credit would be reduced and their financial position would improve if the larger units are instead provided necessary additional bank credit to enable them to make prompt payments for supplies obtained from the ancillary industries and small scale industries. It is relevant to note here that the small scale industries operate in a highly competitive market and cannot, therefore, be expected to pass on the full burden of their interest cost to their buyers. The remedy, however does not lie in charging concessional interest to the small scale sector thereby introducing an element of subsidy, leading to a distortion in credit flows, which we have argued against in Chapter 9. Total interest costs should be reflected in product prices and if a part of these costs need to be absorbed by the producers at the expense of their profits, then this should be a decision to be taken by the larger producers and not forced on the small scale industries sector taking advantage of its weak bargaining power.

12.38 We would also like to draw attention to a broader aspect of the problem referred to in the preceding paragraph. The existence of a large number of small scale industrial units with a precarious financial position and greatly dependent on bank credit is conducive neither to the healthy growth of the industrial sector nor to the effective use of bank credit for

promoting growth in the long run. Monetary regulation measures should, therefore, be directed towards making a positive contribution to the creation of a financially strong and resilient small scale industry and thereby gaining greater flexibility in regard to allocation of credit during ups and downs of industrial activity.

12.39 In the foregoing paragraphs we have discussed various aspects of monetary regulation in so far as they relate to the volume of bank credit and its sectoral allocation. Aspects relating to the cost of credit were discussed earlier in Chapters 9 and 10. There is one other aspect of credit that we would like to comment on at this stage and that relates to the timely availability of credit. We have already referred to the annual credit target and the need for a mid-year review in view of the considerable year to year variability in output and other factors having a bearing on the credit target. Credit targets accordingly must necessarily be pursued in the framework of a limited period of one year, and in a manner conducive to the forging of a close link between credit and output. In other words, variations in the volume of credit to be allocated to different borrowers in consonance with output variations and other factors, need to be quickly achieved through appropriate credit budgeting and credit appraisal procedure of banks. Delays in sanction of higher credit limits or in the review of existing credit limits would reduce the effectiveness of credit and this aspect of credit management should be duly recognised by banks. These measures should create confidence in the borrowers that adequate credit would be available for productive purposes, subject to the overall constraint of a credit target which itself will be responsive to changing price and output trends. As a consequence of such measures, the tendency to 'hoard' additional bank credit on the part of borrowers could well be reduced. This would represent an important gain in terms of a more effective use of credit.

Monetary Regulation and Social Justice:

12.40 In the short run, the single most important contribution which monetary regulation measures can make towards the achievement of the goal of social justice is the maintenance of price stability. The vast majority of those with low incomes need to be assured, even when they remain untouched by developmental activities in the short run, that their incomes, such as they are, will at least be protected from erosion in value due to rising prices. Others who have been covered by development programmes focused on amelioration of poverty will also stand to benefit from price stability. We have dwelt at length in an earlier section on the role of monetary regulation measures in the achievement of price stability. Here we will focus our attention on other aspects of the role of monetary regulation in promoting social justice.

12.41 It is widely recognised that the war on poverty has to be waged for a long time in a populous country like India. The war has to be fought on many fronts and one of them is the programme envisaging the allocation of a portion of bank credit to the priority sector. As of March 1985, banks were expected to reach the target of 40 per cent of bank credit for their advances to the priority sector. Over the years banks have gained considerable experience in regard to organising their lending operations to meet targets set for them from time to time in regard to the level of advances to the priority sector. They have also gained experience in regard to the problems of lending relatively small amounts to a very large number of borrowers. It has to be reiterated that in the case of a substantial part of their advances to the priority sector the banks provide mainly the financial input on the basis of their informed judgement in regard to the viability of the activities proposed to be covered by their priority sector advances. The success of the programmes concerned depend crucially on several other inputs most of which are expected to come from the State Governments and their developmental agencies. The Working Group on the Role of Banks in Implementation of New 20-Point Programme, appointed by the Reserve Bank, which submitted its report in June 1982, has pointed out that "The State Government and their agencies have a variety of responsibilities like systematic identification of schemes and beneficiaries, provision of extension services, linkages and infrastructural facilities, provision of necessary inputs and assistance in marketing end products, technical support in preparation and implementation of schemes, monitoring and ensuring at ground level proper implementation of schemes, conducting techno-economic studies, assisting the timely recovery of loans and arrangements for imparting training to beneficiaries. The achievement of the targets for assisting the weaker sections would depend critically upon the co-ordinated and effective performance of their respective roles by banks as well as Govermental agencies". The major task involved in implementing the programme of assistance to the priority sector lies therefore, in the area of close coordination between banks on the one hand and the State Governments and their agencies on the other. Considering the complexity of the task it is necessary to emphasise that progress can only be achieved through close co-operation among all the agencies concerned, including banks, and no single agency can go far ahead of, or lag far behind, the others in accomplishing its allotted tasks, without jeopardising the programme. Only when this feature of the programme is perceived by each agency concerned as being crucial to the success of the programme will it be possible to expect the desired results to flow from the programme.

12.42 The banks have improved the level and quality of their participation in the priority sector programme over the years. In recent years

the larger banks have set up Regional Rural Banks and this has facilitated their task. The organisational aspects of priority sector lending need to be kept constantly under review in the light of progress achieved in different geographical areas, the nature of activities covered, the problems faced in achieving the necessary coordination among the agencies concerned, the thrust of other policy initiatives in the area of rural development, the results of periodical evaluation of the strengths and weaknesses of the programme and other related aspects.

12.43 A matter of concern from the point of view of monetary regulation is the high overdues which banks are contending against in the implementation of priority sector lending programmes. Considering that as much as 40 per cent of total bank credit is to be allocated to priority sector advances on a sustained basis, high overdues would mean poor recycling of funds. It would also mean that the coverage of the programme in terms of beneficiaries would be lower to the extent overdues are substantial. The overdues might be a result of failure of the scheme financed, wilful default or diversion of bank credit to non-productive purposes, or some deficiency in the programme itself. Whatever the cause, a high level of overdues in respect of a large block of bank credit can only result in adding to the inflationary potential in the economy and eroding the viability of the credit system as a whole. In view of the foregoing we would like to recommend that the Reserve Bank of India may consider ways and means, including legal enactments in consultation with the Government of India, of providing the necessary powers to recover dues expeditiously to the lending agencies concerned, be they banks, or other specialised lending agencies which may be set up over the years for the purpose.

12.44 Expansion in geographical coverage of banks has been an important plank of banking development policy. Considerable progress has been achieved but there is considerable scope for further expansion of banking services in unbanked areas, so that the benefit of banking services can be extended to a larger section of the rural population consisting of a large majority of the poor in the country. Here again organisational problems stand in the way of rapid progress and the time has probably come to consider new ways of tackling these problems. We are not in a position to make specific recommendations in this regard except to suggest that the Reserve Bank of India and the government may consider afresh all the organisational problems relating to the role of banks in financing rural development and further extending banking services in the rural areas, taking due account of the need to ensure cost effectiveness of rural lending, and the possible contribution which local agents could make to this end if their activities are integrated with the lending schemes of banks.

Reserve Bank Credit to the Commercial Sector

12.45 As part of its promotional activities the Reserve Bank has been subscribing to the share capital of various financial institutions and providing credit to them for designated purposes. Such assistance over the years amounted to Rs. 2376 crores as on March 1984. These amounts are shown as a source of reserve money under the head 'Reserve Bank's claims on the Commercial Sector'.

12.46 Apart from investing in shares/bonds of financial institutions, the Reserve Bank makes loans and advances under the Reserve Bank of India Act to several institutions. Short term advances are repayable on demand or within 90 days as may be specified and are made against security. Loans and advances are also made to these institutions for fixed periods not exceeding 18 months. Apart from such assistance, loans and advances are made to IDBI and the EXIM Bank out of the National Industrial Credit (Long Term Operations) Fund. These loans and advances are a part of the RBI's claims on the commercial sector, and as such are a source of reserve money.

12.47 Similarly, loans and advances made out of the National Agricultural Credit (Long Term Operations) Fund and the National Agricultural Credit (Stabilisation) Fund were a source of reserve money till they were transferred to NABARD.

12.48 The surplus of RBI's income after meeting all expenses including payment of interest to scheduled commercial banks on the eligible portion of cash reserve is allocated at the end of each accounting year as under :
year as under :

(1) Contribution to the National Rural Credit (Long Term Operations) Fund established and maintained by NABARD.

(2) Contribution to the National Rural Credit (Stabilisation)Fund established and maintained by NABARD.

(3) Contribution to the National Industrial Credit (Long Term Operations) Fund; and

(4) Surplus payable to the Central Government.

12.49 Since the establishment of NABARD, contributions out of profits are made by the Reserve Bank to the National Rural Credit funds established and maintained by NABARD. Under the scheme for the establishment of NABARD the erstwhile National Agricultural Credit funds of RBI were transferred to NABARD leading to a reduction in the net non-monetary liabilities of RBI. Similarly there was a reduction in RBI's claims on ARDC, State Governments and State Co-operative Banks

and Regional Rural Banks to the extent of loans and advances made to them except those under Section 17(4)(a) pertaining to accommodation for periods of 90 days or less. A part of these claims were, however, replaced by RBI's claims on NABARD. A general line of credit was given by RBI to NABARD and the claims on NABARD just referred to were merged with the general line of credit which is presently shown as a source of reserve money under the head Reserve Bank's claims on NABARD, and not as a part of RBI's claims on the commercial sector.

12.50 The surplus payable to government is temporarily included in non-monetary liability upto the time of transfer to government. Similarly RBI's contributions to the two National Rural Credit funds of NABARD, are temporarily included in non-monetary liability of RBI upto the time of transfer to NABARD and when the transfer occurs, the non-monetary liability goes down leading to an increase in reserve money.

12.51 The National Industrial Credit Fund, like the Reserve Bank's reserve fund, is part of the non-monetary liability of RBI. As of March 1984, the non-monetary liability of RBI in respect of the NIC (LTO) Fund was Rs. 2230 crores against which RBI's claims on IDBI were Rs. 2085 crores and on EXIM Bank Rs. 125 crores. These claims together amounting to Rs. 2210 crores constituted the major portion of RBI's claims on the commercial sector amounting to Rs. 2376 crores.

12.52 The implications of RBI being a source of funds to other financial institutions need to be clearly spelt out. The creation of specific funds pursuant to the developmental role of the RBI is a source of strength to new institutions, and should remain so. However, as institutions grow and attain stature in their respective fields they can and should be able to obtain their working funds ordinarily from sources other than the Reserve Bank. The Reserve Bank's role in supporting such developmental institutions, therefore, needs to be seen in conjunction with its responsibilities in the area of monetary regulation so that reserve money creation is kept within bounds.

Monetary Regulation and the External Sector

12.53 Imbalances in external payments can be corrected by appropriate exchange rate policy or monetary policy. Exchange rate policy has to take into account the distinction between the effective nominal exchange rate and the effective real exchange rate. The nominal 'effective' exchange rate can be defined as a weighted average of the bilateral nominal exchange rates of the home currency against the foreign currencies, trade based weights being used as a proxy for elasticity based weights. The real effective exchange rate can be similarly defined as the nominal effective exchange rate adjusted for changes in the relative prices. Thus

the real effective exchange rate is worked out as a product of the effective relative prices and the nominal exchange rate. An increase in the competitiveness of a country's exports is indicated by a decline in the effective real exchange rate which would be a result of either a depreciation of the nominal exchange rate not offset by higher inflation at home, or a lower inflation in the home country not offset by an appreciation in the effective nominal exchange rate. The real effective exchange rate is therefore a more useful indicator than the nominal effective exchange rate as the real effective exchange rate relates to the economy's competitiveness which has an influence on the country's sustainable current account position. The thrust of exchange rate policy should accordingly be to maintain the real effective exchange rate at a level, as compared to a base period, which ensures the continued competitiveness of the home country. This is to be achieved through varying the nominal exchange rate in the light of movements in the effective relative prices.

12.54 Another aspect of the foreign exchange regime is the role of a fixed nominal exchange rate, a managed (or adjustable) exchange rate or a freely floating exchange rate in achieving a viable external payments position. A recent study* has shown that in the Indian context there is a strong case for opting for an adjustable exchange rate with a view to obtain the desired balance between stability and variability of the exchange rate. The present policy of an adjustable nominal exchange rate should, therefore, provide a suitable basis for maintaining the desired profile of the real effective exchange rate.

12.55 Turning to the question of effective relative prices, monetary policy has also an important role to play in the achievement of reasonable stability in domestic prices. As changes in the Reserve Bank's holding of foreign exchange assets lead to changes in reserve money, these changes need to be closely monitored and suitable action taken to ensure that they do not frustrate efforts to maintain targeted levels of monetary expansion. This is likely to be less difficult in the near term as these assets are not expected to increase sharply over the near future when the balance of payments is likely to be under some pressure arising out of large debt repayment commitments. Nevertheless changes in these assets during a year could be large and either positive or negative thereby introducing a considerable element of uncertainty in regard to the course of changes in reserve money.

Development of a Money Market

12.56 The money market, which is a market for short term financial assets that are close substitutes for money, facilitates the exchange of

* Vijay Joshi "The Nominal and Real Effective Exchange Rate of Indian Rupee 1971-83" (Occasional Papers, Reserve Bank of India, Vol. 5 No. 1, June 1984).

money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market. It provides a mechanism for meeting the liquidity needs of the lenders and the short term requirements of borrowers with the minimum of delay. When tight money conditions prevail the money market rates rise and similarly when easy conditions prevail, the money market rates fall, the fluctuations in the money market interest rates reflecting the demand for and supply of funds in a competitive market. This may not, however, be the case in a system of administered interest rates where interest rates are not permitted to reflect the true scarcity of funds in the money market. The development of an efficient money market requires the development of institutions, instruments, and operating procedures that facilitate widening and deepening of the market and allocation of short term resources with minimum transaction costs and the minimum of delays. In the Indian context this task needs to be performed by the Reserve Bank of India.

12.57 The central bank is itself an important constituent in a money market, in its role as a lender of last resort to banks which form a sizeable segment of the money market. It can influence the cost and availability of funds to the financial sector by influencing the level of liquidity in the economy as a whole through open market operations, and also by regulating the access of banks to its accommodation thereby influencing their lending policies. Thus, the central bank is in a position to play a unique and crucial role in the functioning of a well organised money market, which provides an efficient mechanism for the transmission of the impact of monetary regulation measures to the rest of the economy through the ripple effect. It is for this reason that the development of a money market itself becomes an important monetary regulation measure.

12.58 The money market in India consists of the formal money market and the informal money market. The Reserve Bank, the State Bank of India, other commercial banks, co-operative banks, LIC, GIC and UTI are the main participants in the formal money market at present. The informal market includes a variety of indigenous financial institutions, for example, the indigenous bankers, money lenders, 'Nidhis' and Chit funds among others. In the informal market, there is no clear dividing line between short term finance and long term finance. Further, the lending operations are governed by traditional practices and conventions and restricted to a smaller geographical area. The scale of operations is also relatively small per lender. The short term money market in the formal sector consists of the Treasury Bills Market, the Commercial Bills Market, and the Inter-corporate Market. These are discussed in the following paragraphs.

12.59 Treasury Bills Market : Total Treasury Bills outstanding rose from Rs. 2518 crores in March, 1971 to Rs. 15756 crores in March, 1984. Treasury Bills are held by the Reserve Bank, commercial banks, State Governments and others. As the discount rate on Treasury Bills has been maintained at 4.60 per cent per annum since as long ago as 1974, they do not yield an attractive return and hence are not generally held by investors till maturity. Mostly banks and investment institutions buy Treasury Bills in order to comply with the statutory requirements in regard to investment in government securities and they seek to replace them with government securities carrying a higher yield as soon as possible. The Treasury Bills, therefore, are rediscounted with the Reserve Bank which holds them till maturity. The market in Treasury Bills is presently quite narrow and there is no active market in the real sense of the term. Only if the discount rate on Treasury Bills is suitably revised with a view to provide an acceptable yield to the investor, an active market can be created providing an additional avenue for open market operations. It is important also to develop an active secondary market for Treasury Bills by providing suitable support to brokers and dealers and permitting banks also to avail of their services.

12.60 Call Money Market : The inter-bank call money market is the core of the formal money market. It is presently the most important short term money market. Apart from banks, the participants in the call money market include the insurance companies and the Unit Trust of India. Banks borrow from the call money market in order to meet sudden demand for funds for payments and to obtain funds to meet any likely shortfalls in their cash reserve to meet the CRR stipulation, or in the liquid assets required to be held to meet the SLR stipulation. As Reserve Bank accommodation to banks is not freely made available, policies in this regard being influenced by the monetary policy stance of the Reserve Bank, the inter-bank call money market is the single most important source of over-night and short term funds to banks in urgent need of funds to meet their liquidity requirements. The call loans generally have a maturity of one day to a fortnight. Among the participants in the call money market the State Bank of India is the primary lender, the other important suppliers of funds being the insurance companies and the Unit Trust of India.

12.61 For the banking system as a whole the volume of total call loans was of the order of Rs. 39 crores at end March, 1971. Total call loans of banks rose over the years and amounted to Rs. 427 crores as at the end of March, 1982. They increased to as much as Rs. 848 crores at the end of 1983-84 which indicates the considerable growth of the market in the recent years. The market has grown due to the participation of investment institutions like LIC, GIC and UTI whose supply of call loans to the call

money market has increased substantially. The size of the call money market as compared to the assets of the banking system is still quite small.

12.62 As approved by the Reserve Bank on an experimental basis, participation certificates were being issued by banks since 1970. The scheme became a regular feature in 1977. Participation certificates were brought under the purview of cash reserve and SLR stipulations in July 1979 and as a result this instrument has lost much of its attractiveness to banks, although issue of participation certificates has continued on a lower scale since then. Participation certificates provided the banks with a convenient channel for obtaining short term accommodation from the investment institutions who were able to provide such accommodation during the period which intervened between their cash inflow and the disbursement of funds for capital projects. Participation certificates of this nature deserve to be encouraged. However, in order that they do not result in diversion of funds from investment institutions to banks, for prolonged periods, it might be necessary to place restrictions on the renewability of these certificates. The investment institutions are not expected to place funds other than for short periods with banks, and further, they should try to ensure that their investment in capital projects is not reduced in quantum, or delayed, due to tie-up of funds in the participation certificates. Similarly banks should not attempt to take advantage of the instrument to obtain long term funds which should really be obtained through deposit mobilisation. These considerations should guide the scheme of participation certificates so that the scheme assists both investment institutions and banks without adversely affecting the effectiveness of monetary regulation policies. In view of the freedom which different banks will have in offering different interest rates on deposits, and the greater competition in lending activities among them, which our earlier recommendations envisage, an active instrument such as the participation certificate should be of considerable importance as a means of evening out inter-bank variations in liquidity and providing a profitable short term use of otherwise idle funds of the investment institutions. It is likely that the interest rates applicable to participation certificates will not rise above the interest rate for 1 year deposits which represents a ceiling on the interest rates for deposits of shorter maturity. The use of participation certificates essentially provides a bank an opportunity to increase its lending activity while awaiting deposit accretion, and such increase in lending cannot be sizeable if participation certificates are truly of a short term nature. The participation certificates and Treasury Bills together with the inter-bank call money market would provide an adequate basis for the long term growth of the money market. In order to broaden the market the Reserve Bank may consider permitting additional participants in the inter-bank call money market. In this context it may be noted that funds supplied by non-bank participants of the call money market do not normally re-

present additional funds to the banking system as a whole since the institutional participants would hold their surplus funds in any event as deposits with banks and not in the form of currency. With interest rates as high as 8 per cent per annum currently being offered by banks on even 15 day deposits, these surplus funds may in fact be kept with banks as fixed deposits of 15 days maturity instead of being lent on the inter-bank call money market. Even if they are so lent, one bank would lose the deposit and another would obtain the loan in the call money market. In view of this, additional institutional participants in the call money market may be allowed as they do not constitute an additional source of funds to the banking system as a whole and hence do not dilute the intended effect of monetary regulation measures.

12.63 **Commercial Bills Market:** The volume of bills — inland and foreign — purchased/discounted formed 20.8 per cent of total scheduled commercial bank credit at the end of March 1971. Their proportion to total scheduled commercial bank credit in March 1981 was 12.6 per cent and declined further to 9.9 per cent in March 1984. Sheduled commercial banks had borrowed Rs. 202 crores from the Reserve Bank against usance bills/promissory notes as of March 1971. These borrowings constituted 4.3 per cent of scheduled commercial bank credit outstanding. In March 1976 this proportion worked out to 0.3 per cent, and has been insignificant since then.

12.64 The Reserve Bank has been attempting to develop a market for commercial bills. The Bill Market Scheme was introduced in 1952 and a new scheme called the Bills Rediscounting Scheme was introduced with several new features in November 1970. Under the Bills Rediscounting Scheme the Reserve Bank rediscounts bills at the Bank Rate or at rates specified by it at its discretion. Over the years the rediscounting facility has been made restrictive and at present it is available on a discretionary basis.

12.65 Our earlier discussion on bills has referred to the various impediments in the way of developing a Bill market such as payment of stamp duty, difficulty in obtaining supplies of stamp paper, reluctance on the part of government departments and other large buyers to accept bills, predominance of the cash credit system of lending and the administrative work involved in handling documents of title to goods. We have also made recommendations covering these points, and we have also recommended a concessional rate of interest on bill finance. Development of a bill market requires an adequate supply of first class bills which alone are freely negotiable and marketable. Over the years, banks have not been encouraged to co-accept bills and as a result the bill market does not have an adequate volume of first class bills. An important step that needs to be

taken by the Reserve Bank is to provide the necessary guidelines to the banks in regard to co-accepting of bills. Once policy actions are taken to ensure that a sufficient volume of first class bills comes into being, our other recommendations regarding the development of a bill market become more relevant. An active bill market will relieve pressure on banks for extending credit facilities to sellers or buyers while providing the banks with a financial instrument of acceptable liquidity, safety and return. The facilities of bill rediscounting may be extended by the Reserve Bank to the commercial banks according to the stance of monetary policy at any given time.

12.66 Inter-Corporate Funds Market: Inter-corporate loans have been a traditional feature of corporate financing in India. These loans are generally made by corporate units with seasonal surplus funds to other companies either directly or through brokers. The loans are generally for short periods and may be secured or otherwise. According to the operation of Tandon/Chore norms companies with a current ratio of less than 1.33 : 1 are discouraged from making inter-corporate loans but those with a better current ratio are permitted to make such loans. The share of cash credit in the total of bank credit extended to borrowers in industry and trade would fall if our recommendations are implemented, and the borrowing units will not have the option, to the same extent as at present, to use their surplus funds to reduce the outstandings in their cash credit account and thereby achieve saving in interest cost which currently is of the order of 17.5 per cent per annum. As this implicit return on surplus funds will not be available to the corporate units to any substantial extent there is a need, in the restructured monetary system which we have outlined, to introduce financial instruments in the inter-corporate funds market which will provide surplus units with an acceptable return and the deficit units an acceptable non-bank source of funds. Inter-corporate loans provide these benefits to the corporate units particularly since different units have different seasonal peaks and as such they need not be discouraged. The surplus funds would also find an outlet in the Bill market if the supply of first class bills is ensured. Similarly, these surplus funds may be deployed in the Treasury Bills market once the discount rate on Treasury Bills is raised sufficiently above the current low rate. Evening out liquidity imbalances in the corporate sector through the development of the inter-corporate funds market would provide a means of reducing the variability in the demand for bank credit and hence providing greater manoeuvrability to monetary regulation measures.

Monetary Regulation and Seasonal Factors

12.67 The still dominant influence of agriculture in the Indian economy introduces a marked seasonal influence on the course of eco-

nomic activity. The kharif crop encompasses a wide variety of commercial crops of vital interest to agro-based industries apart from accounting for most of the cereal production other than wheat which is a winter crop. The kharif crop, therefore, significantly influences the level of aggregate demand in the economy as also the level of industrial activity and the volume of traditional exports. Traditionally, the six month period from November to April is considered to be the busy season for economic activity and the period from May to October as the slack season. Accordingly major monetary policy announcements are also generally made twice a year at the beginning of the two seasons.

12.68 Over the recent years the operation of a number of factors has tended to blur the distinction between the busy season and the slack season. First and foremost is the development of the various sectors of the economy under the successive Five Year Plans resulting in a considerable dispersal of economic activity both geographically and sectorally and in the emergence of new productive sectors particularly in the services sector with little or no seasonal content or with fluctuations in activity not related to the agricultural sector. Agriculture itself has seen considerable development by way of increased resort to multiple cropping and other avenues of diversification as a result of which allied activities have grown and tended to be spread over the year as a whole rather than be concentrated in a few months of the year. Import of raw materials like cotton or jute, and import of products like vegetable oils or sugar have made it possible for industrial and related activities to have a second source of supply (other than domestic agriculture) which is not influenced by domestic seasonal factors. As a result industrial and related activities which are agro-based are not as strongly influenced as in the past by the vagaries of the kharif crop and hence exhibit relatively less seasonality.

12.69 The diversification of industry with the development of engineering, chemical, electrical and electronic industries has made industry less dependent on agriculture for raw materials though the market for many of their products depend crucially on agricultural activity and agricultural incomes.

12.70 The diversification of exports resulting in a reduced reliance on export of traditional agro-based commodities has dampened another major source of seasonality in economic activity.

12.71 The banking system has grown phenomenally over the last fifteen years and its considerable rural orientation has introduced a new factor bearing on the seasonality of its operations. It is no longer concerned only with financing economic activities in the fields of industry and trade which gain momentum after the harvesting of crops when raw materials supplies and agricultural incomes come on the scene but is

Table 1a : Monthly Seasonal Factors of Selected Economic Time Series

Name of the series	Year	June	September	December	March	Peak Value	Peak month	Trough value	Trough month
Money Supply (M_3)	1982-83	101.34	98.59	100.95	99.70	101.34	June	99.59	Sep.
	Average	101.49	98.91	100.35	99.69	101.49	June	98.91	Sep.
Aggregate Deposits	1982-83	100.83	99.80	102.41	98.98	102.41	Dec.	98.98	March
	Average	100.70	100.04	102.13	99.05	102.13	Dec.	99.05	March
Loans, Cash-Credits	1982-83	100.62	97.99	102.14	100.37	102.14	Dec.	97.99	Sep.
and Overdrafts	Average	100.86	97.80	102.93	100.61	102.93	Dec.	97.80	Sep.
Wholesale Price Index									
All Commodities	1982-83	100.21	101.83	98.61	98.45	102.86	Aug.	98.45	March
	Average	100.48	101.96	98.74	98.27	102.44	Aug.	98.27	March
Foodgrains	1982-83	98.31	102.35	100.14	98.34	102.35	Sep.	97.28	May
	Average	99.18	102.18	99.83	98.32	102.18	Sep.	97.57	April
Manufactured	1982-83	100.80	102.32	97.89	98.22	102.67	Aug.	97.80	Feb.
Products	Average	100.59	102.77	98.49	97.94	102.77	Sep.	97.63	Feb.

Notes : 1. Seasonal factors are estimated by X-11 variant method and are based on monthly data for the ten year period April 1973 to March 1983.

2. Figures shown against 1982-83 are the estimated seasonal indices.

3. Average values represent the mean values for the entire study period.

Source : Reserve Bank of India Bulletin, January 1984.

Table 1b : Monthly Seasonal Factors of Selected Economic Time Series

Name of the series	Year	April	May	July	August	October	November	January	February
Money Supply (M_3)	1982-83	100.70	100.80	100.36	99.36	99.42	99.12	99.69	99.46
	Average	100.73	101.11	100.57	99.73	99.31	99.14	99.49	99.28
Aggregate Deposits	1982-83	99.38	99.48	99.99	100.08	99.72	99.37	100.25	99.47
	Average	99.36	99.43	100.31	100.20	99.68	99.61	100.09	99.38
Loans, Cash-credits	1982-83	99.25	99.98	100.45	98.64	98.85	98.71	101.76	101.14
and Overdrafts	Average	99.91	100.31	99.78	98.14	98.45	98.50	101.79	100.91
Wholesale Price Index									
All Commodities	1982-83	98.67	99.01	102.35	102.86	100.90	99.43	98.73	98.79
	Average	98.77	99.66	102.17	102.44	100.91	99.63	98.64	98.31
Foodgrains	1982-83	97.31	97.28	100.31	102.12	101.65	101.60	100.21	100.23
	Average	97.57	98.11	100.73	101.96	101.18	101.08	100.18	99.68
Manufactured	1982-83	99.65	99.88	102.12	102.67	101.45	99.13	97.86	97.80
Products	Average	99.03	99.78	101.86	102.35	101.80	99.86	97.89	97.63

also engaged increasingly in financing agriculture and several rural development programmes which have almost an opposite seasonal pattern, as compared to industry and trade. The course of bank credit, therefore, no longer reflects the same seasonality as in the past.

12.72 In view of the operation of the factors discussed in the preceding paragraphs it is possible to conclude that although the dominant influence of agriculture in the Indian economy is still very much evident in the **level** of economic activity and therefore credit in a given year, its impact on the **seasonality** has been diminishing. This seems to be an important distinction to make while considering monetary regulation measures. Data presented in Table I on monthly seasonal factors for the period 1973-83 show that the average seasonal factor for 'loans, cash credits and overdrafts' of scheduled commercial banks was 102.93 for December which was the peak month, and 97.80 for September which was the trough. The difference between the average peak and trough values in respect of aggregate deposits and money supply (M_3) is also of a similar order indicating a degree of seasonality in these series during a year.

12.73 The two major parameters for monetary policy in India appear to be the likely levels of Reserve Bank credit to government as revealed in the annual Budgets which we have discussed at length earlier, and the size of the kharif crop. Accordingly it would be appropriate to announce major monetary regulation measures soon after the Government of India presents its Budget and again after the size of the kharif crop comes to be known with some degree of certainty.

Monetary Regulation and the Parallel Economy

12.74 There has been growing concern in recent years about the influence of the working of the parallel economy on the functioning of the economy as a whole and in particular on the effectiveness of official economic policies. The term parallel economy is generally understood to refer to unrecorded economic transactions involving tax evaded incomes or transactions giving rise to evasion of taxes, taxes here referring to the wide variety of obligatory payments to government such as income tax, wealth tax, excise duties, customs duties, sales tax, stamp duties and so on. Evasion of these liabilities is also often associated with corruption and the problems of enforcing the law in respect of transactions in the parallel economy are therefore found to be quite considerable. There are also problems of evolving precise definitions of tax evaded income or wealth in a country where a large section of the population is not covered by direct taxes. This difficulty adds to the problems of estimating the size of the parallel economy, in whatever way defined, and its influence on the level and nature of economic activity. The government has commissioned a

detailed study on the parallel economy which should provide useful analysis and information facilitating a more technical discussion of the subject. In the absence of the findings of this study at the time of writing, we can only make some general observations in regard to the functioning of the monetary system in the context of the parallel economy.

12.75 Basically, the parallel economy represents an additional source of funds to the economic agents who fail to obtain their requirements from the normal sources, or who need the funds to support activities for which they expect no assistance from the official agencies and other sources. This represents, therefore, a dilution of the effectiveness of credit control measures, and also involves a mis-direction of resources. Unsatisfied demand for credit spills over to the parallel economy to some extent and provides a ready and remunerative outlet for tax evaded incomes. This is particularly so in times of inflation when manufacturers and traders expect to benefit from additional inventory holding. A climate of reasonable price stability and a credit delivery system which succeeds in meeting the genuine requirements of borrowers for approved purposes in time and in adequate measure would reduce this spill over of credit demand and make the operations of the parallel economy less relevant for the monetary system. In this connection the important role of interest rate policy as a price rationing device should also be noted.

12.76 To the extent that funds in the parallel economy have found their way into bank deposits and other savings media they come under the purview of official policies in regard to their use by the recipients. Similarly when expenditures out of tax evaded incomes result in receipts in the hands of those not covered by income tax, a situation arises where the funds so received are no longer distinguishable as funds of the parallel economy. Although tax evaded incomes are partly held in currency, in view of the developments of the type briefly mentioned above a sizeable part could well be found to have been held in other forms of financial or real assets.

12.77 As no data are available which can throw light on this complex set of transactions it is not possible to provide any quantitative dimensions to our comments.

12.78 In the foregoing discussion we have sought to bring out the multi-dimensional characteristics of monetary regulation and discussed the implications for it of the trade-off between different objectives of monetary policy. We have also highlighted the problems of formulating the desired path of monetary expansion taking into account the likely developments in the real sector. The tasks before the Reserve Bank in certain specific sectors influencing the growth in reserve money and the nature of its developmental role have also been commented upon. The

approach to monetary regulation which we have outlined does assume reasonable stability and predictability of the demand for money or alternatively the velocity of circulation. This basic assumption is found to have adequate empirical support but the usefulness of further investigation of the demand for money function should also be stressed. The control of monetary expansion by monetary targeting with feedback provides the necessary flexibility to monetary policy and hence makes its closer integration with other economic policies a feasible and desirable proposition.

Chapter 13: INSTRUMENTS OF MONETARY REGULATION

Having outlined our appoach in regard to the use of monetary regulation meaures to achieve the objectives of monetary policy, we now proceed to examine the factors governing the use of the various instruments of monetary policy in the recent past, and the implications of the recommendations made by us in regard to the restructuring of the monetary system in so far as they relate to the efficiency and scope of the various instruments of monetary regulation.

13.2 Since 1970, the conduct of monetary policy has been influenced by three important factors. Control of inflationary pressures has been one of the major concerns of monetary policy. Measures to enlarge the size of the captive market for government securities to facilitate a significant increase in the quantum of government borrowing at relatively low interest rates have had a notable impact on monetary policy. The substantial growth in the amount of credit provided by the Reserve Bank to government despite the growing size of the captive market,and the falling currency-deposit ratio has at times necessitated strong action to regulate the increase in money supply by influencing the money multiplier and by restricting the growth of Reserve Bank credit to the banking system.The stance of monetary policy in the light of the above factors has generally been restrictive over the past fifteen years, and the instruments of monetary regulation have accordingly been used to achieve the desired degree of monetary restraint while simultaneously ensuring the desired extent of growth in the captive market for government securities.

13.3 The restructuring of the monetary system on the lines recommended by us would provide a significantly different setting for the use of the instruments of monetary regulation as compared to the last fifteen years. With the revision of yields on government securities, the public can be expected to absorb a larger share of government loans floated in the market than in the past, and hence slow down the growth in monetisation of public debt. Higher discount rate on Treasury Bills would also have a similar impact, apart from providing an ideal liquid instrument for the banks and the public. Mobilisation of financial savings would be facilitated by the greater freedom banks would have in determining interest rates to be offered on deposits of different maturities. Banks would also be free to vary their interest rates for bank credit to the non-priority sector and thereby achieve credit regulation to some extent through the pricing mechanism instead of

solely relying on quantitative credit regulation measures.The development of the money market would ease the pressure on banks to meet the credit requirements of trade and industry. The lower reliance on the cash credit method of lending and greater reliance on loans and bills would improve credit planning in banks and lead to better monitoring of the end use of credit. More effective use of credit and monetary targeting would therefore, provide an environment in which there was greater scope for a flexible use of the various instruments of monetary regulation to promote growth in output and restrain inflationary pressures. In the following paragraphs we would therefore like to focus on the various instruments of monetary regulation and examine their role in the restructured monetary system as outlined by us after briefly describing the nature of the instruments and evaluating their role in the past.

13.4 **Cash Reserve Ratio:** Under the provisions of the Reserve Bank of India Act, the scheduled banks were required to maintain with the Reserve Bank every week a minimum average daily cash reserve equivalent to 3 per cent of their demand and time liabilities (DTL) in India outstanding as on the Friday of the previous week. With the enforcement of the relevant amendments to the Act since March 29, 1985, these average balances are to be maintained over each fortnight. The Reserve Bank is empowered to vary the Cash Reserve Ratio between 3 per cent and 15 per cent, no distinction in the application of the ratio being made between demand liabilities and time liabilities. Such a distinction was prescribed under the Act earlier and was removed in 1962.

13.5 Under the provisions of the Banking Regulation Act, the cash reserve ratio applicable to co-operative banks, and non-scheduled banks is 3 per cent and this ratio is not being varied by the Reserve Bank unlike in the case of scheduled commercial banks. These categories of banks are allowed to maintain the cash reserve in the form of cash with themselves or in current account with banks notified in this behalf or partly in cash and partly in such current account. Effective March 29, 1985 the non-scheduled banks are required to maintain, on a daily basis, cash balances required to meet the CRR stipulation over each fortnight; the applicable net demand and time liabilities relate to the level at the end of the second preceding fortnight.

13.6 The 'liabilities' of a bank for the purpose of computation of the cash reserve ratio include net inter-bank liabilities (excess of inter-bank liabilities over inter-bank assets) and liabilities to others but exclude paid-up capital, reserves, credit balances in the profit and loss account, borrowings from the Reserve Bank, and borrowings from IDBI, NABARD and EXIM Bank. If inter-bank assets exceed inter-bank liabilities, the excess is ignored in computing net liabilities.

13.7 Apart from the normal CRR, the Reserve Bank is empowered to prescribe additional cash reserve requirement on incremental deposits accruing from a base date as may be notified by the Reserve Bank. The additional cash reserve requirement, however, are not to exceed 100 per cent of the excess of total demand and time liabilities over the prescribed base level and further they should not result in increasing the effective average cash reserve ratio beyond the statutory maximum of 15 per cent.

13.8 Any shortfall in the maintenance of CRR attracts penal interest at the rate of 3 per cent above the Bank Rate for the first week of default and at 5 per cent thereafter. Further, banks defaulting in regard to the maintenance of CRR are denied access to refinance/rediscount facility since March 30, 1979 and are liable to pay additional interest of 3 per cent on the portion of the accommodation already obtained by them from the Reserve Bank equivalent to the extent of the shortfall. Apart from these stipulations, defaults in regard to CRR attract graduated penalties from January 1982 by way of loss of interest on the portion of their cash reserve eligible for payment of interest by the Reserve Bank. In the case of CRR shortfalls upto and inclusive of an amount equivalent to 4 per cent of the absolute amount of cash balances required to be maintained there is no penalty on the shortfall. Further, in the case of shortfalls upto 3 per cent, banks would be paid interest on a graduated scale on the eligible balances actually maintained.

13.9 Out of the required reserves actually maintained to meet the prescribed CRR, that portion which exceeds the reserves required to be maintained to comply with the statutory minimum cash reserve ratio of 3 per cent is eligible for payment of interest, if a bank has complied with the CRR as prescribed. The rate of interest paid on these additional reserves has been raised over the years, and was raised to 9 per cent per annum effective May 1, 1983, and to 10 per cent per annum effective November 16, 1984. No interest is paid on excess reserves which are defined as cash reserves in excess of those required to meet the prescribed CRR. Additional cash reserves relating to incremental demand and time liabilities over the prescribed base date are also eligible for payment of interest in the same manner as reserves maintained to meet the normal CRR. It may be useful to note that the total cash reserves that are actually maintained by a scheduled commercial bank consist of a) the minimum statutory cash reserve of 3 per cent, b) additional reserves to meet the difference between CRR and the statutory cash reserve of 3 per cent, c) the additional cash reserves relating to incremental demand and time Liabilities (DTL) as may be prescribed from time to time and d) excess reserves over and above the level required to comply with the prescribed cash reserve requirements,or shortfalls therein. The Banking Laws (Amendment) Act, 1983 (Act 1 of 1984), prescribes that the computation of the average daily cash balances pursuant to the CRR stipula-

tion is to be made for a fortnight instead of for a week as previously prescribed. This change was brought into force on March 29, 1985.

13.10 The Cash Reserve Ratio was originally specified as 5 per cent of demand liabilities and 2 per cent of time liabilities. With an amendment to the RBI Act, in October 1956 the CRR was made variable between 5 per cent and 20 per cent of demand liabilities, and between 2 per cent and 8 per cent of time liabilities. The cash reserve requirements were, however, fixed at the minimum specified levels, viz., 5 per cent of demand liabilities and 2 per cent of time liabilities. Additional cash reserve requirements were imposed in 1960 when 25 per cent of the increase in net DTL since March 11, 1960 was impounded; this was raised to 50 per cent of the increase in net DTL on May 6, 1960. These requirements were withdrawn on November 11, 1960. On September 16, 1962, the ratio was fixed uniformly at 3 per cent of demand and time liabilities and made variable between 3 per cent and 15 per cent. The subsequent changes in the CRR are presented in Table 1.

13.11 Prior to April 9, 1982, Non-Resident (External) Accounts in Rupees attracted the same CRR as applicable to the local rupee deposits from time to time. From April 9, 1982 the CRR is, however, prescribed at 3 per cent on these deposits. On Foreign Currency (Non-resident) Accounts, the CRR has been prescribed at 3 per cent from November 1975 when these accounts were first permitted to be maintained. The banks were also called upon to deposit from the week beginning July 1, 1978, with the Reserve Bank, in terms of rupees, the equivalent of one half of the net aggregate amount which accrued after June 1, 1978 under the Non-Resident (External) Accounts in rupees and Foreign Currency (Non-Resident) Accounts. This requirement was withdrawn on June 5, 1979 and the amount earlier impounded has been allowed to be set off by the banks against their obligations under CRR. Further, FCNR and NRE Accounts were not covered by the stipulation effective November 1983, in regard to additional cash reserve.

13.12 The Cash Reserve Ratio is a highly effective instrument of monetary regulation. Its quick and predictable impact makes it a very useful anti-inflationary tool and as such particularly suited to the Indian context where a sudden rise in the price level by 15-20 per cent has occurred every few years, since 1966, most often triggered off by failure of the monsoon. Since 1973 the CRR has been used not only in the context of a sharp rise in prices in a given year but also as a primary instrument to counter the inflationary pressures resulting from large continuing budgetary deficits. The growth of reserve money from a level of Rs. 4,391 crores in March 1970 to Rs. 28,821 crores in March 1984, mainly accounted for by a rise in the level of RBI cre-

Table 1 : Changes in Cash Reserve Ratio

(Per cent of net DTL)

Effective Date	Level	Extent of Increase	Extent of Decrease	Additional Cash Reserve on Incremental net DTL over a base date
1962 Sept. 16	3			
1973 June 29	5	2		
Sept. 8	6	1		
Sept. 22	7	1		
1974 June 29	5		2	
Dec. 14	4.5		0.5	
Dec. 28	4		0.5	
1975 Nov. 1*				
1976 Sept. 4	5	1		
Nov. 13	6	1		
1977 Jan. 14				10% on net DTL accruing since Jan. 14, 1977
1978 June 1*				
1979 June 5*				
1980 Oct. 31				10% incremental as above withdrawn; the balances not released.
1981 July 31	6.5	0.5		
Aug. 21	7	0.5		
Nov. 27	7.25	0.25		
Dec. 25	7.50	0.25		
1982 Jan. 29	7.75	0.25		
April 9*	7.25		0.5	
June 11	7.00	0.25		
1983 May 27	7.50	0.5		
July 29	8.00	0.5		
Aug. 27	8.50	0.5		
Nov. 12				10% on net DTL accruing after Nov. 11, 1983.
1984 Feb. 4	9.0	0.5		
Oct. 27				One-fifth of additional cash balances as on 31.10.80 released in two instalments on these dates.
Dec. 1				

* Certain changes in respect of FCNR and NRE Deposits were effected as indicated in para 13.11

dit to government, is itself indicative of the degree of inflationary potential in the economy which has witnessed, on an average, annual growth in net national product of less than four per cent. Further, during this period the currency-deposit ratio declined from 0.67 to 0.30 contributing to a higher value of the money multiplier. In these circumstances, the use of the CRR as an important weapon of monetary control was increasingly in evidence and epitomised the cautious if not restrictive monetary policy stance since mid-Seventies. Several factors such as the limited scope for open market operations in the absence of an active market for government securities, the low levels of refinance which had already been achieved resulting in little scope for further curtailment, the continued popularity of fixed deposits with banks as a mode of financial savings in the absence of other competing financial instruments, in the aggregate led to the adoption of the CRR as a major instrument of monetary control together with refinance in respect of food credit.

13.13 The effectiveness of the CRR instrument has been augmented on occasions by imposing an additional cash reserve requirement, over and above the CRR specified from time to time. This has taken the form of a cash reserve related to the growth in deposits beyond the level attained by a bank on a specified date. This incremental CRR is said to have the merit of distinguishing between banks whose deposit growth has been sluggish and those having a high rate of growth. It would, however, appear to be an inappropriate measure to provide relief to banks whose deposit growth is relatively low. The weaker banks could always be assisted through suitable refinance measures and we, therefore, do not see any merit in imposing an extra burden on the banks who have secured a relatively high deposit growth, and thereby demonstrated their greater effectiveness in the deposit mobilisation drive. The burden can be quite heavy since additional DTL beyond the level attained on the specified date attract the normal CRR stipulation and also an additional cash reserve requirement at a rate which could exceed the normal CRR. This approach also permits the less aggressive banks to be content with their loan portfolio rather than make efforts to improve the quality of their portfolio through more effective supervision of end use of credit, when credit is sought to be made more scarce through the upward revision of CRR. We, therefore, recommend that the practice of stipulating an additional CRR requirement on incremental deposits be adopted very sparingly, for short durations, and only in special circumstances requiring drastic monetary control measures. Even if an incremental CRR is imposed, it should be converted to an average at an appropriate time.

13.14 In the restructured monetary system which we have recommended, there would be less need to resort to variations in CRR as a primary monetary policy tool as was probably unavoidable in the recent past. As

monetisation of debt is reduced there would be less upward pressure on reserve money levels. Monetary targeting would be facilitated by the suggested co-ordination between the Reserve Bank and the government in the matter of determining the likely extent of growth in RBI credit to government, which in the past has been the main source of reserve money. Further, the buoyancy of deposits is likely to be lower as savers would be induced to hold a larger volume of government securities. The element of price rationing in the allocation of credit over and above the quantitative credit control measures would also be in operation to a greater extent than at present. In this setting, open market operations and refinance policies would normally provide a sufficient means for keeping money supply and credit on the targeted path. Upward revision of CRR would then be available for use as an effective weapon on occasions when output growth falls short of expectations or when a combination of circumstances threatens to raise the price level sharply.

13.15 Statutory Liquidity Ratio: Central banks generally require commercial banks to hold liquid assets such as government securities against their deposit liabilities in addition to a cash reserve requirement. This is known as supplementary reserve requirement or secondary reserve requirement. The main objectives sought to be achieved by this measure are, (a) to assure solvency of commercial banks by compelling them to hold low risk assets upto the stipulated extent, (b) to create or support a market for government securities in economies which do not have a developed capital market, and (c) to allocate resources to government for augmenting the resources of the public sector.

13.16 Imposition of secondary reserve requirements permits the central bank to insulate from the open market that portion of government debt which the banks are required to hold to satisfy the secondary reserve requirement. This technique therefore prevents the banks from disinvesting government securities in favour of commercial credit even when there is an incentive for such an action.

13.17 In India the secondary reserves are prescribed by the Banking Regulation Act 1949. Under this Act the banks are to maintain, at the close of business every day, a minimum proportion of their total demand and time liabilities in India as liquid assets in the form of cash, gold and unencumbered approved securities. The ratio of liquid assets to demand and time liabilities in India is known as the Statutory Liquidity Ratio (SLR). The level of SLR which was stipulated in the Banking Regulation Act till recently was a minimum of 25 per cent to be maintained on any day. The ratio has been gradually increased for scheduled commercial banks other than Regional Rural Banks from time

to time through RBI policy announcements, particulary since 1970 (Table 2). With the amendment to the Banking Regulation Act in 1983, the Reserve Bank is empowered to increase Statutory Liquidity Ratio for scheduled commercial banks upto 40 per cent. The amendments relating to SLR came into force on March 29, 1985. The components of cash as prescribed in the Act include cash in hand, balances in the current account with the State Bank of India (SBI) and notified banks such as subsidiaries of SBI, nationalised banks, and balances with the Reserve Bank in excess of the amount required to be maintained on account of the stipulated Cash Reserve Ratio (including additional cash reserve requirement if in force) from time to time. In the case of non-scheduled banks since all the above assets are eligible for meeting the cash reserve requirement also, it is only the excess holding of these assets over the stipulated cash reserve that can be considered in the computation of SLR. It was clarified in October 1984 that for purposes of computing SLR the excess balances with the Reserve Bank over the stipulated CRR requirement should be computed on the basis of the excess of **average** daily cash balances with RBI actually held for the week ending Friday over the average daily balances stipulated under CRR. As the SLR requirement will be monitored on a daily basis over each fortnight effective March 29, 1985, instead of on Fridays which was the case prior to March 29, 1985, there could be a problem in that, while meeting the SLR on a daily basis, the excess cash balances with the RBI as are permitted in the computation of SLR requirement, cannot be determined on an average basis until the relevant fortnight comes to an end. Considering the complications involved in evolving a suitable procedure for the purpose, and the administrative cost of computing such excess balances and verifying them as a control measure, we are of the view that the Reserve Bank should consider initiating necessary amendments to the statute with a view to eliminate the link presently provided by cash between the computation of the CRR requirement and that of the eligible assets for meeting the SLR requirement. This objective can be achieved by stipulating a Statutory Investment Ratio instead of the present SLR. The eligible assets for the Statutory Investment Ratio could be the same as for SLR barring cash and gold, and hence the Statutory Investment Ratio will have to be specified at a slightly lower level compared to the SLR. As the applicable net demand and time liabilities are known well in advance, and Treasury Bills can be purchased without delay and also yield a positive return unlike cash and as uncertainties relating to the level of cash on any day will no longer be pertinent to the computation of eligible assets, the banks should have no difficulty in complying with the Statutory Investment Ratio. This appears to us to be a feasible solution to the problem we have mentioned.

13.18 Approved securities broadly include the securities issued by government and various local bodies as also securities enjoying the guaran-

Table 2: Changes in Statutory Liquidity Ratio

Year	Month	Changes in SLR	
		From	To
		%	%
1964	September	20	25
1970	February	25	26
	April	26	27
	August	27	28
1972	August	28	29
	November	29	30
1973	December	30	32
1974	June	32	33
1978	December	33	34
1981	September	34	34.5
	October	34.5	35
1984	July	35	35.5
	September	35.5	36
1985	June 8 (yet to be effective)	36	36.5
	July 6 (yet to be effective)	36.5	37

tee of government in regard to payment of principal and interest. Important approved securities in the portfolio of banks other than government securities, are the bonds of IDBI, NABARD, IFCI, SFC s,co-operative debentures, debentures of State electricity boards, and State road transport corporations etc. Some trustee securities, however, are not approved securities for the purpose of computing the SLR. They include securities secured by a first mortgage of immovable property, units of the Unit Trust of India, and other securities that have been specifically notified as trustee securities subsequent to the passing of the Indian Trust Act.

13.19 The demand and time liabilities (DTL) to which the liquid assets of banks are to be related for computing the SLR include all liabilities except paid-up capital and reserves, borrowing from RBI, and borrowing from IDBI and NABARD. In the case of central co-operative banks, their borrowings from State co-operative banks are also excluded from the total liabilities for this purpose. Effective March 29, 1985 the specified demand and time liabilities are, however, on a **net** basis as for CRR.

13.20 Historically, the objective of SLR in the Indian context was to impose financial discipline on the banks and to provide some protection to the depositors. The Statutory Liquidity Ratio remained unaltered at 20 per cent for a considerably long period between 1949 to 1964. As can be seen from Table 2 the ratio was raised to a minimum of 25 per cent in Septemeber 1964 pursuant to an amendment to the Banking Regulation Act in 1962. Further, under this amendment, balances maintained by banks with RBI in fulfilment of the cash reserve requirement were not to be treated as a constituent of eligible liquid assets for the purposes of SLR computation. The ratio was raised above the level of 25 per cent for the first time in February 1970 by a RBI directive in the case of scheduled commercial banks. Since then the level of SLR has been successively stepped up. The higher liquidity ratio has provided an expanding captive market for government securities and hence served as a means of allocating a larger share of banks' resources to government.

13.21 Till March 1979, additional interest on refinance accommodation was not charged on shortfalls in reserve requirements of banks. Subsequently banks defaulting on their CRR and SLR requirements were required to pay additional interest of 3 per cent per annum on the portion of any accommodation already availed of from the Reserve Bank equivalent to the shortfall in the CRR/SLR requirements. In certain periods, however, banks have been exempted from the levy of additional interest.

13.22 During the period 1970-1984 scheduled banks' holdings of government securities fluctuated within narrow limits and averaged about 22 per cent of the total demand and time liabilities. The value of government securities, in other words, acounted for about two-third of the prescribed liquid assets in recent years.

13.23 The coupon rates on new issues of securities of the Government of India as well as other approved securities have been gradually raised over the years. The raising of coupon rates on new issues of securities results in a decline in the market price of securities issued earlier at lower coupon rates, in the wake of an alignment of yields of securities of comparable maturity. While the depreciation of securities affects all investors, the impact on banks is of considerable importance in view of its implications for SLR and other accounting purposes.

13.24 Depreciation in the value of government securities held already in the portfolio of banks compels the banks to purchase additional liquid assets to satisfy the SLR requirements. Recognising this impact of the upward adjustment in yields on government securities, the Reserve Bank has in the past given some relief to the banks in regard to the method of valuation. The

valuation of government securities for the purpose of SLR was made on the basis of the current market prices of the securities upto 25 per cent of the demand and time liabilities as specified in the Banking Regulation Act till it was amended recently. Beyond this level the value of government securities was to be ascertained on the basis of book value, adjusted for provision of depreciation in the value of investments, the adjustment being limited to the value of the relevant securities. This concession was first extended for a few months in 1974; since 1980 this partial exemption was granted on a six monthly basis. The position has radically changed since March 29, 1985 with the implementation of the revised method of valuation as determined by the Reserve Bank.

13.25 In terms of the Banking Laws (Amendment) Act 1983 the Reserve Bank is empowered to impose penalties for defaults. It has also been specified in the amended Act that the net demand and time liabilities relevant for the computation of SLR would be those pertaining to the end of the second preceding fortnight. The SLR requirement can, therefore, be quite precisely determined even after allowing for delays in getting information about variations in the level of demand and time liabilities and hence banks should have no difficulty in meeting SLR requirements on a daily basis as prescribed under the Act.

13.26 The mode of valuation of the securities for the purpose of the SLR requirement is to be determined by the Reserve Bank under the provisions of the amendments to the Banking Regulation Act brought into force on March 29, 1985. The Reserve Bank has specified that the value of the unencumbered securities for the purpose of the SLR computation should be determined on the same basis as heretofore in respect of those securities held by the banks on March 29, 1985 and the value so determined by the banks will be deemed to be frozen till the securities are redeemed or sold. If there is any appreciation in the market value of that portion of the securities held by banks on March 29, 1985 to meet the minimum SLR of 25 per cent as on that date the banks may take the benefit of the appreciation for purposes of determining the value of eligible assets for meeting the SLR requirement and further they may ignore any depreciation in the market value of those securities which might occur after March 29, 1985. This new mode of valuation provides a measure of relief to the banks in regard to their SLR obligation. In regard to those securities held on March 29, 1985 as eligible assets for purposes of meeting the SLR obligation in excess of the minimum SLR of 25 per cent, the specified mode of valuation effective March 29, 1985 is that they should be valued either at book value less provision, if any, for depreciation in the market value as on March 29, 1985, or at market price on that date or at the current market prices. In a departure from previous practice it has also been decided that securities acquired after

March 29, 1985 are to be valued on the basis of face value or cost price whichever is lower and they will continue to be so valued subsequently regardless of the market value. As a result of these changes in the mode of valuation of approved securities held by banks for purpose of meeting their SLR obligation, changes in market prices of approved securities arising from changes in coupon rates of new issues or changing conditions in the capital market will not adversely affect the value of the approved securities already acquired by the banks. Accordingly, in future government securities can be issued with a greater degree of flexibility in regard to coupon rates.

13.27 The rapid growth of bank deposits since 1970 has resulted in absorption of a substantial volume of government securities by banks. The ratio of government securities to total demand and time liabilities has, however, not increased over the years, as other approved securities with a higher yield have been acquired by banks to meet the rising SLR requirements. As a result, the rising volume of government securities has not been fully absorbed by institutional investors and banks, the residual being absorbed by the Reserve Bank and contributing to monetisation of debt. As the low yields on government securities had an increasingly greater impact on the profitability of banks as SLR was raised over the years, there was not much scope for raising SLR further to reduce monetisation of debt. Given the government's market borrowing programme there was also no scope for reducing SLR levels. The SLR has hence not been a flexible tool of monetary policy except to the extent it provided a means of transferring bank resources to government and specified public sector agencies in a somewhat predictable manner.

13.28 Our recommendations aimed at facilitating the sale of government securities to the non-institutional public as an additional channel of market borrowing by government would lend an element of flexibility to the SLR instrument. As the yields on government securities would not be pegged at artificially low levels, acquisition of government securities need not unduly depress the profitability of banks. Higher SLR levels could, therefore, be specified for short periods, when absorption of government securities by the public or the growth of bank deposits fall below estimated levels, so that the need for the Reserve Bank to support the government's market borrowing programme is minimised and monetisation of debt avoided to that extent. Similarly, variations in SLR could be effected in conjunction with variations in the cash reserve requirements in situations where changes in SLR are likely to result in changes in the desired direction in the portfolio of government securities held by the Reserve Bank. The use of SLR requirement in these ways would expand its role as a tool of monetary policy beyond the traditional one of allocating bank resources to government. A flexible SLR instrument would accordingly enhance the effectiveness of monetary regulation measures.

13.29 Refinance Policy: The system of refinance provided by the RBI to the scheduled commercial banks has generally functioned as one of the most active instruments of credit regulation in India. The relative importance of this measure in different periods has obviously depended on the degree of liquidity constraint experienced by the banking system. However, the need to control the growth of lendable resources with the banks being the predominant concern of monetary policies over the past decade, the refinance and rediscount accommodation has been conceived as having a significant role in determining the quantum as well as cost of bank credit at the margin.

13.30 Like RBI credit to government, RBI accommodation to banks by way of refinance or rediscounting *ceteris paribus* augments their reserves and consequently helps to further expand credit and money supply. While each segment of the refinance accommodation to be granted to individual banks may appear desirable and necessary such accommodation in the aggregate may surpass the limit which is in consonance with the targeted growth of money supply and credit based on macro economic considerations. These may entail contraction of the overall reserve base of banks, but the selective supply of 'reserves' to banks to enable them to dispense credit for specific purposes, even as the growth in money supply is sought to be curtailed through the raising of the cash reserve requirement or other means represents a means of achieving discretionary policy objectives. Thus the effectiveness of this instrument gets diminished as the preferred sector refinancing schemes multiply, and when the refinance rates are fixed at levels affording considerable latitude to banks to increase their entitlement. Also, a bank may attempt to avoid the rigours of the restrictive or regulatory nature of refinance and rediscount policy through the acquisition of funds from other external sources such as the call money market and the participation certificates (non-bank) but such funds have not been substantial in the past. Again, defaults by banks on the cash reserve and statutory liquidity requirements may follow highly restrictive refinance policies. These factors may at times blunt the efficacy of the refinance policy instrument.

13.31 The regulation of access to refinance facilities has been effected through a combination of raising the cost of such accommodation and/or regulating its availability against eligible assets. Major modifications in the policy effected since 1960 are of interest and may be briefly traced here. Between October 1960 and September 1964 the Reserve Bank operated a quota cum slab interest rate system. Banks were given a basic quota equivalent to a specific percentage of the statutory cash reserve requirement. Upto this quota banks could obtain Reserve Bank accommodation at Bank Rate. An additional quota of accommodation equivalent to basic quota or sometimes more than the basic quota was also available, but the rate of interest charged on this slab of borrowing was at a higher rate. Borrowing beyond even the

additional quota was on a 'special accommodation' basis at the discretion of the Reserve Bank and at a still higher rate of interest. The quota system sought to exercise a quantitative check on RBI refinance combined with a measure of cost escalation for such borrowing. The basis on which quotas were fixed was uniform and all banks were treated equally. It failed to take into account the differences in the asset distribution of the different banks and their ability to pass on their higher effective cost of funds to their borrowers by raising lending rates. Consequently this system did not prove to be an effective constraint on banks' lending operations.

13.32 To tide over this problem the concept of net liquidity ratio was evolved. This ratio was defined as the ratio of the aggregate of a bank's cash balances with the Reserve Bank and with other banks in current account, and all its investments in approved securities less its total borrowings from the RBI, State Bank of India and Industrial Development Bank of India, to its total demand and time liabilities. The application of this concept implied that the larger the recourse of banks to RBI, IDBI or SBI, the greater the impairment of liquidity. Similar was the effect if the banks disinvested securities or rediscounted the Treasury Bills. As long as the net liquidity ratio was at or above a certain norm, refinance was provided at Bank Rate, and for every percentage point drop from the minimum ratio the rate of interest on the entire lending was fixed at progressively higher levels. The minimum net liquidity ratio, and the maximum penal interest rate underwent changes in pursuance of the credit policy in force from time to time. The NLR system had the effect of limiting the availability of resources to banks through higher cost of central bank credit.

13.33 The refinance facilities were considerably modified in the Seventies; in response to the situation arising from relatively larger increase in bank credit and pressure on prices, automatic access to refinance facilities within the Net Liquidity Ratio System which gave the banks larger potential to borrow from the RBI at or above the Bank Rate was stopped in 1973. The normal facility of virtual automatic borrowings from the RBI under section 17 of the Reserve Bank of India Act was restricted to a stipulated ceiling for each bank known as basic borrowing limits which varied between 1 and 2 per cent of bank's total demand and time liabilities for different periods upto end May 1974; it has been since lowered to one per cent of bank's demand and time liabilities. The need to tighten the refinance facilities resulted in the discontinuance in November 1975 of the Net Liquidity Ratio system. Thereafter all refinance accommodation, apart from the basic refinance limit and refinance for food procurement advances, was then made strictly at the Reserve Bank's discretion as to the quantum, duration and rate of interest, attention being paid to the banks' adherence to credit policy guidelines.

13.34 Effective July 1, 1978, automatic refinance quota of 1 per cent of their demand and time liabilities was discontinued, and for meeting clearing imbalances RBI provided refinance facilities under stand-by/discretionary arrangements for a period of not more than 3 days. The access to such refinance was given in exceptional cases. With effect from July 1980 the facility of stand-by refinance was made available only against the collateral of government securities and trustee securities, the rate of interest charged being lower than the discretionary rate. This was of course in addition to refinance provided against food procurement credit and export credit which in a sense is automatic beyond the threshold level fixed by RBI. The interest rate on stand-by refinance is currently 12.5 per cent having been raised to this level in April 1985 consequent to the increase in the interest rates on government securities over the years. The minimum interest rate on discretionary refinance currently stands at 14.0 per cent, and the interest rate currently applicable to export refinance is 10.0 per cent. The rate for food refinance is currently 10.0 per cent which will go up to 11.5 per cent effective October 1, 1985.

13.35 The scope of refinance as an instrument to regulate credit expansion is related to the extent of dependence of commercial banks on the Reserve Bank. Where commercial banks' indebtedness to the monetary authorities is small, as a result of availability of funds from other sources, the role of this instrument would evidently be marginal. In such cases other instruments of monetary policy need to be relied upon to a greater extent. These instruments to become fully effective, however, need to be supported by a flexible refinance policy.

13.36 The data on trends in total refinance that has been extended by the Reserve Bank during the last fifteen years suggests that over the years commercial banks' recourse to the Reserve Bank for financing credit expansion tended to come down substantially in response to the policy in this regard. Further, the growth in reserve money arising out of the Reserve Bank's lending to commercial banks was mostly on account of banks' lending to preferred sectors. Reduced dependence of banks on the Reserve Bank for resources has over the years reduced the effectiveness of discretionary refinance as a credit regulation measure, more so since a sizeable proportion of such refinance was on account of lending for preferred purposes. This, however, does not deny the supportive role played by refinance policy in reinforcing the impact of other credit policy instruments deployed from time to time.

13.37 In the restructured monetary system which we have outlined, reserve money expansion is not likely to be occasioned by large increases in Reserve Bank credit to government unlike in the past. This provides greater

flexibility to the Reserve Bank to vary rates of expansion in reserve money and money supply as dictated by developments in the economy. In this context the refinance instrument could be effectively used in conjunction with other measures of monetary regulation, since greater variations in the quantum of refinance would become a feasible proposition in contrast to the situation in the recent past, thereby providing the Reserve Bank with an additional lever to control the operations of banks.

13.38 **Refinance of Food Credit:** The history of fluctuations in the production and prices of foodgrains underlined the urgent need for building a sizeable buffer stock in the public sector. Prudent management of such an inventory has a vital role to play in the overall price stabilisation policy in addition to facilitating the implementation of a rational food policy. Adequate stocks of foodgrains enable the government to intervene in the market to discourage speculative tendencies and ensure appropriate supplies. The need to build buffer stocks of foodgrains provides the justification for launching a sustained food procurement operation.

13.39 Procurement, storage and distribution operations of foodgrains such as paddy, wheat, jowar and other coarse grains of the magnitude that had been undertaken in the recent past evidently require substantial resources. The financing of procurement operations was mostly met out of budgetary resources uptil 1970.On a limited scale financial accommodation was also provided by a few banks particularly the State Bank of India and its associate banks who in turn were provided refinance by the Reserve Bank at the Bank Rate. Since 1969, however, the Food Corporation of India (FCI) has been mainly responsible for food procurement; initially the equity funds of the Corporation and loans given to it by the government financed this activity. The involvement of banks in this area was enlarged with the formation of the food credit consortium in April 1970. The consortium comprising the State Bank of India, its associate banks and public sector banks financed the credit needs of the FCI, the State Governments and other state level agencies engaged in procurement and distribution of foodgrains. Subsequently private sector banks and foreign banks were also asked to join the consortium. Apart from the FCI, 29 major central/state government agencies are presently involved in food procurement operations, finance for which is provided by a consortium of 36 banks. The limits of different borrowers are fixed by the Reserve Bank of India with reference to the level of procurement activity from time to time and advised to the State Bank of India. The credit is first made available by the SBI as the leader of the consortium and thereafter shared with other banks in the proportion determined by the Reserve Bank on the basis of the share of deposits (weekly averages) of concerned banks in the total deposits outstanding in the preceding fiscal year.

13.40 The full responsibility for financing food procurement operations was formally transferred from the budget to the banking system in 1975-76. This decision of government brought about a change in the role of bank finance from provision of finance for normal trade turnover to the extension of credit for price support and buffer stocking operations, which implied that a sizeable amount of commercial banks' resources had to be earmarked for this purpose on a pre-emptive basis, since banks were given virtually no choice regarding their participation. In order to regulate the impact of this policy on the quantum of bank resources available to other sectors the scheme of refinance of food credit came into being.

13.41 In keeping with the need for regulating the expansion in reserve money, the proportion of food credit supported by Reserve Bank refinance has been sought to be varied, the refinance formula being adjusted according to the overall liquidity position and the stance of monetary policy.

13.42 The interest rate prescribed for food credit extended by banks has been low, but has been raised in stages from 9 per cent in 1974. The rate of interest on food credit was raised from 12.5 per cent to 14.0 per cent effective October 1, 1984. The rate on refinance which was being provided by the Reserve Bank at an interest rate of 10 per cent since July 1981 will be raised to 11.5 per cent in October 1985 consequent on the announced increase in the interest rate on food credit.

13.43 The banks' involvement in financing public food procurement of foodgrains has added a new dimension to the refinance policy. The option to decide what proportion of increments in the quantum of food credit should be met from banks' own resources and what proportion should be eligible for refinance by the Reserve Bank serves as an effective and flexible instrument of monetary management. That the Reserve Bank has been taking recourse to this instrument repeatedly to control the reserves of banks is evident from the number of changes in food refinance policy indicated below :

Period	Food Refinance Policy (Number of Changes)
1960/61 - 1969/70	—
1970/71 - 1972/73	5
1973/74 - 1974/75	4
1975/76 - 1978/79	5
1979/80 - 1980/81	2
1981/82 - 1982/83	6

13.44 Since November 1970 the Reserve Bank has been providing refinance of food credit to banks beyond a threshold specified in terms of the outstanding level of food credit extended by them. They, accordingly, were required to provide food credit up to the specified threshold from their own resources. The threshold for food credit refinance as well as the rate of interest on such facility were varied by the Reserve Bank from time to time having regard to the state of liquidity in the banking system, prospective trends in production and procurement of foodgrains.

13.45 The pre-emption of a sizeable portion of the lendable resources of banks by food credit and their deployment at a rate of interest lower than the commercial rate reflects the vital significance attached to buffer stocking of foodgrains in the overall price stabilisation policy. The special treatment accorded to official agencies trading in foodgrains is not accorded to organisations dealing in other commodities although official agencies trading in fertilisers, cotton and jute have been claiming an increasing share of bank credit in recent years.

13.46 Over the years food credit has been claiming not an insignificant portion of the banks' resources and presently, on an average, food credit accounts for about ten per cent of the total bank credit. Food refinance facilities are thus an important factor affecting reserve money generation. It may be noted that the mechanism of allocating food credit among different banks, and the refinance arrangements for food credit, distribute the responsibility for providing food credit as also the benefits of refinance uniformly over all banks in the consortium depending on their size. The prescribed spread of 2.5 per cent between the interest rate on food credit and the rate of interest on food credit refinance cannot be considered unremunerative to banks. This is because the administrative cost of raising the additional resources as also the administrative cost and default risk associated with normal credit operations are all virtually absent in the case of food credit operations to the extent they are eligible for refinance from the Reserve Bank. This is not to deny, however, that banks have a narrow spread between the interest rate that they are permitted to charge for food credit and their average cost of funds when they provide food credit from their own resources. Since food credit is the first charge on lendable resources of banks, and since the threshold for food credit refinance is being raised continually, the rate of interest prescribed for food credit has to be kept under review so that it bears a reasonable relation to the average cost of funds for banks.

13.47 **Open Market Operations:** Open market operations are conducted by a central bank mainly with a view to directly or indirectly affect the reserves of banks and thereby the extent of monetary expansion and in the

process to create and maintain a desired pattern of yield on government securities and generally to help the government raise resources from the capital market. Thus this policy instrument has two aspects viz. the monetary policy aspect and the fiscal policy aspect. For the conduct of open market operations as a monetary instrument the market for government securities should be well organised, broad-based and deep, so that the central bank is in a position to sell and buy securities to the extent it considers desirable. A prerequisite for the emergence of such markets is that the rate of interest offered on government securities is competitive. Since these conditions are not met by the Indian capital market, open market operations are of minor importance as a monetary instrument though they serve as an adjunct of fiscal policy in India to some extent.

13.48 Section 17(8) of the Reserve Bank of India Act confers legal powers on the Reserve Bank to use this instrument of monetary policy. Under this Section the Reserve Bank is authorised to purchase and sell the sucrities of the Central or State governments of any maturity and the security of a local authority specified by the Central Government on the recommendation of the Bank's Central Board. However, at present the Reserve Bank deals only in the securities issued by the Central Government and not in those of State Governments and local authorities. Parenthetically it may be noted that in terms of Section 33 of the Reserve Bank of India Act which lists the assets to be kept in the Issue Department, securities issued by the State Governments or local bodies are not eligible to be used as reserve assets against note issue.

13.49 Originally, the Reserve Bank of India Act stipulated that the amount invested in Government of India rupee securities should not at any time exceed one fourth of the total amount of assets or fifty crores of rupees, whichever amount was greater; an increase in the ceiling by Rs. 10 crores was permitted with the previous sanction of the Governor General in Council. This provision was deleted in 1941 and as such there is no limit on the amount of securities that could be bought or sold in open market operations. The restrictions on the Reserve Bank on holding of securities of certain maturities were also removed in 1951. The Reserve Bank is also authorised under the Reserve Bank of India Act to purchase and sell commercial bills of short-term nature. However, in practice, as noted earlier, the Reserve Bank's open market operations are confined only to Central Government dated securities. The securities directly bought by the Reserve Bank at the time of loan floatation are excluded from the definition of open market operations, since such purchases are deemed to be on a temporary basis and the securities would be sold in the market as and when the market's absorptive condition improves. Although open market operations have resulted in net sales in each of the years during the period 1971-1983 (Table 3) the holdings of Central Government dated securities by the Reserve Bank

have steadily increased indicating the continued support by the Reserve Bank to the market in Central Government securities. During the three year period April 1981–March 1984, despite net sales under open market operations amounting to a total of Rs. 1,010 crores, Central Government dated securities held by the Reserve Bank rose by Rs. 3,615 crores. The gross market loans floated by the Central Government during this period were of the order of Rs. 1,1678.50 crores.

Table 3: Open Market Operations

(Rupees Crores)

Year ending June	Purchases @	Sales	Net Sales
1971	207	313	106
1972	189	245	56
1973	317	460	143
1974	226	305	79
1975	371	645	274
1976	680	1,187	506
1977	412	943	531
1978	559	1,190	631
1979	364	1,038	674
1980	776	1,119	343
1981	454	796	342
1982	1,007	1,078	71
1983	1,039	1,828	790

Note: Figures are inclusive of purchases and sales on behalf of the State Governments.
@ Excluding the Reserve Bank's subscriptions to Central Government loans.
Source: Report on Currency and Finance (Reserve Bank of India).

13.50 The government securities market in India is narrow and is dominated by financial institutions especially by commercial banks. The Reserve Bank of India occupies a pivotal position in the market. It is continuously in the market, selling government securities, of different maturities on tap; it stands ready to buy them in switch operations. The Reserve Bank does not ordinarily purchase securities against cash. There are no dealers in the market who are engaged in continuous sale and purchase of securities on their own account. Incidentally, it may be noted that the Reserve Bank effects purchases and sales from time to time out of the surplus funds of

IDBI, Exim Bank, and NABARD under a special arrangement. The market, however, is served by stock brokers who act as intermediaries between prospective buyers and sellers of government securities. The Reserve Bank also enlists the services of brokers. Only a few of them are said to be active in the securities market.

13.51 The facility of switch transaction involving purchase of one security against the sale of another is provided by the Reserve Bank to the banks and other financial institutions in order to enable them to improve yields on their investments in government securities. In the case of normal switch transactions, an investor is enabled to swap low yielding securities against higher yielding ones from the stocks available with the Reserve Bank either directly or through the brokers. In a 'triangular' switch operation, one institution's or investor's sale or purchase of security is matched by the purchase or sale transactions of another institution. Therefore, the triangular switch operations require the services of brokers who promote inter-institution dealing in securities.

13.52 The Reserve Bank fixed an annual quota for switch transactions for each bank in July 1973 and these quotas were raised in November 1975. The quota which was uniform for all banks initially, is fixed in relation to the size of banks determined on the basis of their time and demand liabilities at the end of each fiscal year. The objective in fixing a quota for switch deals is to prevent the banks from resorting to excessive sale of low yielding securities to the Reserve Bank.

13.53 The Reserve Bank maintains separate lists of securities for purchase and sale transactions. Different scrips are included in the two lists having regard to the stock of the securities and dates of maturity of different loans. Prior to 1978, the Reserve Bank was also buying securities which were on the sales list and also selling securities which were on the purchase list to ensure ready marketability of government securities. This practice has been discontinued since January 1978, and securities placed in the sales list are presently not bought under normal circumstances. As an exception, however, the Reserve Bank sells securities placed on the purchase list to Provident Funds.

13.54 One of the unique features of trading in the gilt edged security market in India is what is referred to as the "voucher benefit". This practice is viewed as a factor instrumental in spurring activity in the gilt edged market. Bye-laws of the various stock exchanges stipulate that bargains in government securities and bearer or registered debentures shall be deemed not to include the accrued interest in the price and such bargains shall be subject to interest being accounted for between buyer and seller separately.

It is further laid down that when accrued interest is not included in the bargain price, the seller shall be entitled to receive from the buyer the interest accrued till date of payment less the amount of income-tax and surcharge deductible at source at the time of half-yearly payment of interest on government securities. The amount of tax so deducted on a *pro rata* basis is retained by the buyer and no credit for tax deduction is given to the seller. The proportionate deduction of tax on the amount of interest retained by the seller is based on the consideration that the buyer would be paid interest on the due date after deduction of the tax due on the full interest amount. Technically speaking, although this method may not be inappropriate, there is an aspect to it, which is difficult to justify. The buyer on the interest due date gets an income tax deduction certificate in respect of the **total** tax deducted at source on the amount of **gross** interest, i.e. including the tax deduction applicable to that portion of interest which has accrued to the seller. This certificate which is commonly called the voucher enables the buyer to set off the total amount of tax deducted at source against his final tax liabilities. On the other hand, the seller does not receive any tax certificate on a *pro rata* basis in respect of the amount of tax deduction at source applicable to the portion of interest earned by him although he has received, at the time of sale, interest only **after** deduction of an amount representing *pro rata* deduction of tax at source. The banks and financial institutions whose earnings are taxed find it advantageous to purchase the securities around the interest due date and unload them in the market after availing themselves of the voucher for the full half-year. The Reserve Bank being the main dealer in the gilt-edged market and also exempt from the payment of any tax, voucher trading confers benefits mainly on the banks.

13.55 What could be said in favour of "voucher trading" is that it creates a condition of active trading in the scrips around interest due dates. But this active trading, it should be recognised, does not partake the character of genuine trading. In fact, prevalance of this practice renders it necessary for the Reserve Bank to fix quotas in regard to switch transactions, suspend trading in a particular scrip for one month before the interest due date etc., which to some extent restricts the freedom of participants in the market. The objection to the discontinuation of this practice would be that it might cause a fall in the volume of transactions in government securities. Considering the nature of trading which takes place because of voucher benefit, this argument does not survive strict scrutiny. We have made several recommendations which have a bearing on broad-basing of the market for government securities, particularly aimed at securing much greater participation of the public than has been evident in recent years. We, therefore, recommend that the implications of 'voucher trading' to the development of a broad-based and active market in government securities should be carefully examined by the Reserve Bank and

government and suitable action taken in this regard. The scope for using open market operations as an active instrument of monetary regulation would also be influenced by institutional arrangements such as 'voucher trading' affecting the interests of buyers and sellers in the market for government securities.

13.56 Despite the relatively low level of interest rates offered on government securities, there has been a notable growth in the size of the gilt-edged securities market, *albeit* captive in nature. There have been no upheavals in the market which ruled steady mainly as a result of intervention by the Reserve Bank.

13.57 The role of open market operations as an instrument of credit control will assume importance in the restructured monetary system recommended by us. With the interest rate offered on government securities becoming truly competitive, a broad enough securities market may emerge for the Reserve Bank to use open market operations as an instrument of credit control.

13.58 **Bank Rate Policy:** The Bank Rate, one of the instruments of general or quantitative credit control represents, as the Reserve Bank of India Act defines, the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the provisions of the Act. In the context of the undeveloped state of the bill market and lack of eligible paper for discounting, however, the Bank Rate in India is essentially the rate at which the Reserve Bank extends advances to various categories of borrowers. Even this description is not apt presently, for there is no longer a single rate which is applicable to advances by the Reserve Bank, differential rates being prescribed for various types of refinance facilities provided by it.

13.59 The impact of a change in the Bank Rate depends upon such factors as the extent of commercial banks' dependence on the Reserve Bank for funds, the availability of funds to banks from other sources, the extent to which other interest rates are directly influenced by changes in the Bank Rate, and the degree of importance attached to a change in the Bank Rate as an indicator of the stance of monetary policy.

13.60 In view of these pre-conditions for an effective Bank Rate policy it is not surprising that the Bank Rate as an instrument of monetary control has fallen into disuse in India. Several factors such as the inherent inflexibility involved in the use of this instrument, the dominance of the public sector whose investment requirements are cost inelastic, and the higher rate of inflation experienced since mid-Sixties which rendered any minor change in the Bank Rate ineffective, and restricted availability of

refinance facilities to banks over and above those earmarked for specific purposes, have together contributed to the ineffectiveness of moderate changes in the Bank Rate. Around the time when the Reserve Bank was established, all financial accommodation was provided at the Bank Rate except the ways and means advances to the Central Government and State Governments. Subsequently, the rates at which Reserve Bank provided refinance varied depending upon the nature and type of activity for which refinance was sought.

13.61 Recourse to the Bank Rate in order to control monetary expansion has been rather limited especially since the mid-Seventies as can be seen from the data presented in Table 4. Significantly, in the recent history of operation of this instrument, the Bank Rate was lowered only once in 1968.

13.62 The cost of credit to the ultimate borrowers in different segments of the economy is presently sought to be regulated by directly prescribing the commercial banks' lending rates, rather than acting through the Bank Rate.

Table 4: Changes in Bank Rate

Period	Level of Bank Rate (per cent per annum)
December 1951	3.5
June 1957	4.0
January 1963	4.5
October 1964	5.0
March 1965	6.0
March 1968	5.0
January 1971	6.0
June 1973	7.0
August 1974	9.0
July 1981 — to date	10.0

13.63 In the restructured monetary system which we have outlined there would be scope for improving the effectiveness of this instrument of monetary regulation particularly if necessary steps are taken to develop an active money market as recommended by us. Further, if banks' recourse to Reserve Bank accommodation rises as a result of our recommendations relating to regulation of reserve money expansion, the Reserve Bank will be in a better position to influence banks' operations through Bank Rate policy. Again, the interest rates on Reserve Bank credit to the commercial sector could be specified only in relation to the Bank Rate.

13.64 Selective Credit Control :Selective credit control is operated as an adjunct to general credit control. It is intended to ensure an adequate credit flow to the desired sectors while preventing excessive credit drawal for less essential economic activities. In India the term is used to refer to the policy directives issued by the Reserve Bank of India under Section 21 of the Banking Regulation Act 1949. to regulate the flow of bank credit against the security of selected commodities. Selective credit control is usually applied to achieve a reduction in excessive advances against certain sensitive commodities in short supply and to reduce pressure on demand originating from bank credit.

13.65 This instrument was introduced in May 1956 by the Reserve Bank as there was general indication that bank accommodation was utilised for hoarding of paddy and rice. The scheme has undergone considerable modifications since then and we undertake a brief review of the scheme here. A number of commodities have been covered at one time or the other on the consideration that their production has a tendency to fluctuate and hence there exists a potential danger of speculative holdings of these commodities in an inflationary situation. The controls have been tightened, relaxed or annulled depending upon the trends in demand and supply position of the concerned commodities. The commodities covered are (i) foodgrains i.e., cereals and pulses, (ii) selected major oilseeds indigenously grown and oils thereof, vanaspati and all imported oilseeds and vegetable oils, (iii) raw cotton and *kapas*, (iv) sugar/gur/khandsari, and (v) cotton textiles (till January 1985).

13.66 The Reserve Bank of India operates selective credit control through one, or a combination, of the techniques of (i) minimum margin for lending against the value of specified securities (ii) ceiling on the level of credit and (iii) minimum rate of interest on advances, apart from prohibiting grant of credit against book debts as well as grant of clean credit. The first two measures seek to control the quantum of credit and the third has a bearing on the cost of credit. The margin control is intended to act on the demand side by making such borrowings costlier while the ceiling impinges on the supply side.

13.67 The Reserve Bank has been prescribing minimum margin for advances against commodities under selective credit control. To begin with there was a single margin for each commodity. Subsequently, separate margins have been stipulated on the basis of level of stocks, type of borrower, variety of commodity, nature of credit instrument and documents, regions, stocks earmarked for free sale or otherwise, and public and private sectors.

13.68 Margins affect the drawing power of the borrower against a speci-

fic value of stocks. This control measure has been supplemented by the prescription of the maximum limit on level of advances against specified commodities, which means that the banks are not free to extend credit exceeding these limits against these commodities even if margin requirements are satisfied. In the beginning banks were asked not to grant fresh credit limits to individual parties in excess of Rs. 50,000/–. They were also requested to try to bring down the level of advances against specified commodities to a level not more than 125 per cent of that in the corresponding period of the previous year. In 1957, the Reserve Bank shifted to a stricter practice of laying down for each bank the aggregate level of advances against specified commodities. In 1972, the basis for the permissible limit for advances against selective credit control commodities was changed from bank-wise to party-wise limits in order to prevent the banks from utilising unutilised credit limits for other borrowers. This also reduced the latitude available to the banks to reallocate the limits between various borrowers often to the detriment of smaller parties. The ceiling on credit was limited to the peak level of credit utilised by the borrower in any one year of a three-year period specified by the Reserve Bank. It is necessary for banks to obtain prior clearance of the Reserve Bank to grant fresh advances or enhance the existing limits.

13.69 Complete exemptions have been granted to certain areas and categories of transactions from the applicability of provisions of selective credit control. These include a few States in the eastern and northern parts of the country, public procurement, storage and distribution agencies including co-operative marketing federations and central and state warehousing corporations, rice mills acting as agents of government, rationed foodgrains dealers and consumer co-operatives, demand documentary bills, packing credit for exports, farmers, primary co-operatives, hybrid seeds and certain categories of manufacturing and processing units.

13.70 All the three instruments of selective credit control are applied to advances against foodgrains, oilseeds, (other than rape seed and mustard seed), vegetable oils and cotton and *kapas*. In the case of advances against rapeseed/mustard, sugar/gur/khandsari and cotton textiles minimum margin and minimum rate of interest are applicable. Further there was restriction on credit against cotton textiles to traders, dealers and agents till January 1985.

13.71 Since control has to be exercised to prevent the financing of speculative activities in the selected commodities without at the same time affecting normal production operations which require certain amount of stocking of raw materials, the scheme in relation to mills/factories is somewhat liberal. The minimum margins on advances to producers are

generally lower than those for others. The hoarding of stocks of materials and finished goods even by manufacturers cannot be ruled out. Therefore margins on advances to manufacturing units are generally related to size of stocks or the number of weeks' consumption which the stocks represent and higher margins are stipulated against additional stocks of materials as also finished goods.

13.72 In pursuance of the recommendations of the Study Group to Frame Guidelines for Follow-up of Bank Credit certain norms have been prescribed by the Reserve Bank in respect of select industries. In cases where advances are subject to both the Tandon Committee norms and selective credit control the lower quantum is considered for determining the amount of advance. Bank advances against the security of any of the foodgrains where a ban on trading has been imposed are not granted except in respect of (a) wholesale or retail traders, who are authorised by government to deal in the foodgrains and (b) processing units to the extent to which and the manner in which such processing is allowed by government. Stock limits prescribed by government, have to be kept in view by banks while determining the extent of credit facility to any party.

13.73 Monitoring of trends in bank credit against selected commodities is done in the RBI periodically having regard to the trends in their production and prices. Appropriate changes in policies are made from time to time. The follow-up of implementation of the instructions given in the RBI directives is done by the Reserve Bank's Department of Banking Operations and Development in its general inspection of branches and offices. In addition special inspections are also arranged of the implementation of selective credit control at the branch level in selected centres.

13.74 To what extent selective credit policy measures have attained their objectives is a question that does not lend itself to any easy evaluation. As noted earlier the primary objective of the control has been to check speculative hoarding and consequential price rise in selected commodities. Inflation, be at the aggregate level or sectoral level is a complex phenomenon. The influence of bank credit is but one among the various forces affecting demand and supply, the imbalances in which exert pressure on prices. If the influence of other factors affecting demand and supply is strong, the price rise in individual commodities could be aggravated by the easy availability of bank credit for the purpose of stock holding.

13.75 However, the business community can and does take recourse to other sources of finance outside the organised money market and thus thwart the objectives of selective credit control. It would perhaps be in-

appropriate to judge the efficacy of selective credit control measures in terms of their impact on prices. The destabilising effect of supply of finance from sources other than the organised sector is an argument that has relevance in any assessment of the influence of credit policy measures in general. Financial accommodation provided by banks against sensitive commodities covered under selective credit control account for about 3 to 4 per cent of total bank credit. In the case of trading in individual commodities the use of bank finance has been estimated to be low in relation to the total finance. Successful restriction of the supply of bank credit against the specified commodities as and when such commodities come under inflationary pressure, could be regarded as an index of the effectiveness of this policy instrument. In the absence of such credit control, there would have occurred unrestricted supply of bank credit for socially undesirable activities of hoarding of essential articles by unscrupulous elements. The bank advances against commodities covered under selective credit control as a proportion of total bank credit have fallen considerably since 1971 although the quantum of finance rose sizeably.

13.76 Selective credit control has been in operation for nearly three decades now. It has been used in conjunction with other general credit policy measures to attain the wider monetary policy objectives. Over the years the system has grown in complexity. The margins stipulated in respect of the same commodity are many and at times very high. A number of prohibitory directives have been issued to the banks against making clean advances to parties dealing in selected commodities, permitting utilisation of permissible limit under one selected commodity for financing another commodity, discounting of usance bills arising out of sale of commodities under selective credit control etc. The banks in their submissions to the Committee while conceding the usefulness of qualitative credit controls, stated that the procedural guidelines in respect of selective credit control are cumbersome. They felt that the limits sanctioned against the commodities covered under the scheme are inadequate and that there is need to review the number of commodities covered under the selective credit control. In short a need is felt for a detailed appraisal of the operation of these qualitative control measures. In fact if prescription of margins is to serve as a flexible instrument of control, it must be varied depending on the situation. In this context we note with interest the measures for the simplification of selective credit control announced by the Reserve Bank in April 1985. The different levels for margins have been drastically reduced in number, and the limit for advances per borrower which do not attract any provisions of selective credit control has been raised from the earlier limit of Rs. 5,000 to Rs. 25,000, so long as the borrower deals only

with one bank. Such a simplification of selective credit control was probably long overdue.

13.77 **Interest Rate Policy:** We present in Table 5 and Table 6 the changes in deposit and lending rates respectively of scheduled commercial banks which give an indication of the extent of the use of this instrument over the recent past. We have already commented at length on interest rate policy and made various recommendations which are aimed at restoring it to the position of an effective instrument of monetary regulation.

13.78 **Moral Suasion:** A central bank at times seeks to influence the volume and directional flow of credit by appeal and voluntary compliance of the guidelines by banks rather than enforced compliance of its directions. This instrument of monetary regulation which is known as moral suasion is found to be particularly effective in regulating the growth of liquidity in the economy. Moral suasion may be attempted in the form of advice on the desirable expansion of bank credit, loan priorities, maintenance of liquid assets, etc. The Reserve Bank of India is using the instrument of moral suasion regularly. Letters are issued by the Reserve Bank to the banks at the commencement of the busy season and the slack season and also from time to time reviewing the trends in the economy and monetary and credit developments and enlisting the co-operation of the banks in maintaining credit guidelines in the background of these developments.

13.79 The role of moral suasion as an effective instrument of monetary regulation can be seen in the maintenance of the Statutory Liquidity Ratio by the banks. While banks were statutorily required to maintain a minimum of 25 per cent of their demand and time liabilities, as a result of moral suasion by the Reserve Bank they maintained higher ratios indicated by the RBI over the years. Quantitative ceilings on expansion of non-food credit which were imposed as a part of the restrictive monetary policy during the 1973-74 busy season have since become a regular feature and these are sought to be made effective through moral suasion. Similarly, banks have been exhorted to achieve the targets set in regard to lending to the priority sector and in this regard too moral suasion has been the primary tool employed by the Reserve Bank.

13.80 Moral suasion is a means of strengthening mutual confidence and understanding between the monetary authority and the banks as well as financial institutions and therefore is an essential instrument of monetary regulation.

13.81 The discussion in the preceding paragraphs has been aimed at

Table 5: Interest Rates on Bank Deposits*

(per cent per annum)

Effective date	1 Year Deposits	Deposits Above 5 Years
April 1, 1970	5.50	6.75@ 7.00@@
January 11, 1971	6.00	7.25
April 1, 1974	6.75	8.00
July 23, 1974	8.00	10.00
June 1, 1977	6.00	10.00
March 1, 1978	6.00	9.00
September 13, 1979	7.00	10.00
March 2, 1981	7.50	10.00**
March 1, 1982	8.00	10.00**
October 26, 1982	8.00	11.00£
April 8, 1985	8.5	

* As applicable to scheduled commercial banks.
** 3 Years and above.
@ 5 to 6 years.
@@ Above 6 years.
£ Five years and above.

Note:

1. From October 2, 1975, the Regional Rural Banks (RRBs) were permitted to pay on deposits accepted by them interest higher by 0.50 per cent per annum than those prescribed for specified categories of deposits for periods up to 5 years. From January 1, 1977 deposits with a maturity of more than 5 years were also covered. But, from June 1, 1977, RRBs were allowed to continue to pay 0.50 per cent more on fixed deposits of 5 years only. From March 2, 1981, the higher rate was allowed to be paid on term deposits of less than 3 years' maturity.

2. Since March 1, 1982, commercial banks which are authorised to deal in foreign exchange and which accept term deposits having a maturity period of 1 year and above under the FCNR Account scheme and NRE Rupee Account scheme pay on such deposits interest at the rate of 2 per cent per annum above the rates specified for other deposits as allowed by RBI.

Table 6: Lending Rates of Banks*

(per cent per annum)

Effective date	Prescribed Minimum Lending Rate	Prescribed Maximum Lending Rate			Tax on interest income
		For Banks with DTL Above Rs. 50 crores	For Banks with DTL Rs. 25 crores to 50 crores	For Banks with DTL Less than Rs. 25 crores	
June 1973	10.0				
December 1973	11.0				
July 1974	12.5				
August 1974					A tax of 7 per cent on the interest income of scheduled commercial banks on loans and advances was introduced.
March 15, 1976		16.5	17.5	No ceiling	Inclusive of interest income tax.
March 1, 1978		18.0	15.0	16.0	Tax on interest income abolished.
September 13, 1979		18.0	18.0	19.0	
July 1, 1980	13.5	19.4	19.4	20.5	Tax on interest income reimposed.
March 2, 1981	General minimum lending rate was abolished	19.5	19.5	19.5	Lending rates were made uniform irrespective of size.
April 1, 1983		18.0	18.0	18.0	Tax on interest income halved.
April 1, 1985		17.5	17.5	17.5	Tax on interest income abolished.

* As applicable to scheduled commercial banks.

clarifying the role of the various instruments of monetary regulation in the restructured monetary system which we have outlined. The restructuring of the monetary system as recommended by us enhances the effectiveness of the various instruments of monetary regulation by providing a suitable policy environment for their effective use, and by facilitating the development of a monetary targeting framework which could set the parameters for evolving a judicious mix of these instruments to achieve desired goals. The manner in which the individual instruments could be sharpened has also been commented upon though it is to be stressed that refashioning of these instruments has to be an ongoing process as situations change and new demands come to be made on them. A caution which needs to be sounded on the basis of recent experience is that the conduct of monetary policy should not be dependent excessively on any single or just a few instruments of monetary regulation, and attempts should be made to use all available instruments in the right combination in performing the task of monetary regulation. This approach would be justified in the context of the considerable uncertainties in the course of developments in the real sector which might entail on occasion a quick and decisive response of the monetary authority which can be forthcoming only if the tools at their command are not blunted by over-use. Raising CRR levels, restricting refinance levels, raising interest rates, reliance on quantitative credit control, all have their limits in terms of effectiveness over a prolonged period unless they are flexibly used, and so to say 'rested' for certain periods for possible future use.

Chapter 14 : MONETARY RESEARCH AND STATISTICS

Reliable and up-to-date information about the movements of various economic and financial indicators is essential for the formulation and implementation of monetary policy and for monitoring the impact of the economic policy measures undertaken in the economy as also of international economic developments. Besides facilitating policy formulation and monitoring of the course of economic activity in general, monetary and other financial statistics are utilised for research purposes and for the general information of the public. These statistics also provide a quantitative framework of the financial system as a whole within which monetary developments take place and hence are to be analysed. Apart from being reliable and up-to-date as far as possible, economic statistics should be clear in respect of concepts and definitions of terms, comprehensive in coverage and comparable over time and spatially.

14.2 The Reserve Bank of India issues several periodical publications which contain a comprehensive account of its operations and a vast volume of data together with an account of the trends and developments in the economy as a whole and money, banking and other financial sectors in particular. These publications contain valuable statistical information useful for research workers and the general public. A list of Reserve Bank's regular publications is given in Table 1. The Reserve Bank also brings out special publications and monographs from time to time dealing with the problems of agricultural finance, company finance, balance of payments, etc. which have a unique place in the economic information system in the country. Several surveys like the All India Debt and Investment Survey are also being undertaken on a regular basis. There has been a steady improvement in the collection, compilation, coverage and publication of various economic and monetary statistics.

14.3 The Reserve Bank of India Bulletin which is a monthly publication presents a review of the current monetary and financial developments along with current economic, monetary and banking statistics relating to various facets of the economy. The Annual Report of the Reserve Bank provides a comprehensive review of the trends in the economy during the preceding year (July-June) and an assessment of the current situation and the future outlook. It also provides the background against which the Reserve Bank had to pursue its monetary policies and an assessment of the impact of monetary policy measures.

14.4 The Report on Currency and Finance, an annual publication, provides a description of economic and financial developments in the country and is an invaluable reference work to all engaged in research and policy formulation in regard to matters relating to the Indian economy. The other important publications of the Reserve Bank are the Report on Trend and Progress of Banking in India, Statistical Tables Relating to Banks in India and Banking Statistics : Basic Statistical Returns (BSR), the first two being annual publications and the third half-yearly. These contain comprehensive statistical information relating to banks apart from a review of the growth and development of banks in India and their functions and working.

14.5 The supplement to the RBI Bulletin which is a weekly publication provides information on important monetary and price data on a weekly basis. As regards aggregative data on money and banking it is observed that provisional data are available with a lag of 10-15 days, and are published in the weekly supplement. Partially revised data are available within six to seven weeks. These are published in the RBI Bulletin which is at present being published with a lag of 3 to 4 months. Final data on money and banking are available within 6 months but are published only after one year. These can perhaps be published earlier in the weekly statistical supplement as soon as final data become available.

14.6 The Statistical Tables Relating to Banks in India and BSR are available with a lag of about three years. Thus much of the operational utility of these important publications is lost.

14.7 Recent data on bank deposits according to type of deposits are not available. They are only available in BSR (half-yearly basis) and Statistical Tables Relating to Banks in India. Maturity-wise data on fixed deposits are not available regularly. They are published on an *ad hoc* basis with a considerable time-lag in the Statistical Tables Relating to Banks. It needs to be emphasised here that maturity-wise classification of fixed deposits is an important piece of information from the point of view of formulating appropriate interest rate policy according to the term structure of deposits and assessing the importance of interest rate changes on the composition of fixed deposits. It is, therefore, necessary that the relevant data are regularly collected and published.

14.8 Information on bank credit covering details of bank lending to the public sector and private sector enterprises is not provided either in RBI Bulletin or in the Report on Currency and Finance. They are available in BSR with a considerable lag.

14.9 Information on balances maintained by banks with the Reserve

Bank is being published but no break-up of these balances between those constituting minimum balances required to be maintained pursuant to the CRR stipulation and the balances which are in excess is being presented. This additional information will be very useful to research workers, even if this is published with some lag due to administrative reasons.

14.10 Data on various categories of refinance assistance by the Reserve Bank to banks are not being published. It is desirable to publish the same even if this involves a time-lag, and also for the past years.

14.11 Data on co-operative banks are available only in the 'Statistical Statements Relating to Co-operative Movement in India' on an annual basis with a considerable lag and are not available as a guide to decision making. It is desirable that these data may be published with a reduced time-lag.

14.12 The coverage of money supply data widened from 1970-71. The new series are available from 1970-71 onwards. However, data published in the RBI Bulletin for the financial year as well as in the Report on Currency and Finance are not uniform. For some years the data are presented for the last Friday of March. In other years the data relating to RBI are presented as on March 31 on the basis of closure of government accounts, while data relating to banks are as on last Friday. It is desirable to publish an uniform series of money supply data as of last Friday of March as well as on the last day of the financial year pertaining to government accounts.

14.13 Data on demand deposits and time deposits, and money supply data from March 1978 are not comparable with the earlier period due to changes in the basis of apportionment of savings deposits into demand and time liability components. We recommend that the Reserve Bank should provide a meaningful and continuous time series of money supply, covering the narrow as well as the broader definitions, for the past three decades to facilitate analytical studies.

14.14 As observed earlier, there is considerable delay in the publication of Basic Statistical Returns and Statistical Tables Relating to Banks in India. It is desirable that the time lag is reduced. Advance summary results could be published and data based on sample surveys could also be published early so that current research work is not handicapped for want of recent estimates.

14.15 The flow of funds data being published provide an useful account of the financial transactions in the economy and the changing

structure of assets of the financial institutions. Additional data relating to the banking sector may be published on an annual basis.

14.16 Timeliness of company finance data has shown improvement. However, no information is available on the current trends in investment expenditure, inventories, etc. in the corporate sector which are needed for the formulation of monetary and credit policies. A quarterly survey on a sampling basis would provide some useful information on these aspects. A survey could be conducted on the investment intentions of the companies and such anticipatory data are necessary to understand the behaviour of the economy in the short-term.

14.17 Data on household savings in the form of financial assets also need improvement. In the flow of funds accounts and savings estimates the household sector includes unincorporated enterprises and, therefore, they do not give a realistic picture of personal savings. A sample survey may be conducted to estimate the savings of the unincorporated enterprises to get an estimate of the savings of this sector. Information on credit extended to private consumers, loans for housing, loans for hire-purchase are useful data as they throw light on the changes taking place in the liquidity in the personal sector, and hence may be compiled and published.

Table 1: Important RBI Publications

	Name of publication	Periodicity
1.	Reserve Bank of India Bulletin	Monthly
2.	Weekly Statistical Supplement to RBI Bulletin	
3.	Annual Report of the Reserve Bank of India	
4.	Report on Trend and Progress of Banking in India	Yearly
5.	Report on Currency and Finance	Yearly
6.	Statistical Tables Relating to Banks in India	Yearly
7.	Banking Statistics: Basic Statistical Returns	Half-yearly
8.	RBI Occasional Papers	Half-yearly
9.	Credit Information Review	Monthly

14.18 **Research :** At present research work undertaken in the Reserve Bank on various aspects of the economy including money and finance are being published in Reserve Bank of India Occasional Papers which is brought out twice in a year. Some of the speeches of the senior executives of the Reserve Bank published in the Bulletin are based on research work undertaken on special topics.

14.19 There is need however to undertake more intensive research on various aspects of the Indian monetary system. Comprehensive research studies on the demand for money in India need to be undertaken. The estimates of the elasticity of personal savings with respect to interest rates and the influence of interset rates on the public's holding of fixed deposits of various maturity require further investigation. Not many analytical studies are availablewith a focus on the factors affecting the demand for bank credit. Relationship between money, output and prices is another area of research having policy implications which needs more interim probings than it has received thus far.

14.20 The Reserve Bank may also encourage research by research institutions and individual research workers. The Reserve Bank's effort in this direction, it is hoped, would facilitate informed discussion and promote studies of high quality on important subjects relating to monetary and financial developments in the economy.

Chapter 15: SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

1. We note with interest the role assigned to monetary policy and credit policy, as early as in the First Five Year Plan, in regard to allocation of resources and price policy. The First Five Year Plan recognised the role of prices as a factor in determining resource allocation in a mixed economy but emphasised that the direction of investment need not solely be guided by profit considerations. Nevertheless, the Plan also cautioned that 'the relationship between costs and returns even in the public sector has to be judged at least as a first approximation in terms of market prices.' Accordingly the First Five Year Plan emphasised the role of monetary and credit policy as an important instrument for maintaining price stability and for regulation of investment and business activity. The Reserve Bank was, therefore, expected to play its part in furthering economic development along agreed lines by aligning the banking system to the needs of a planned economy. (Paragraphs 2.5 and 2.6)

2. It is clear that the operation of the monetary system should be consistent with the priorities laid down in the Plans so that the process of mobilisation of savings and utilisation of these resources becomes 'socially purposive' as rightly emphasised in the First Five Year Plan. (Paragraph 2.8)

3. The growth in output achieved over the Plan periods was accompanied by notable structural shifts in the composition of output. A major transformation has also taken place in the industrial organisation with the growth and development of the public sector. The average share of the public sector in GDP increased from 8.5 per cent during the First Five Year Plan period (1951-56) to 23.2 per cent in the first four years of the Sixth Plan (1980-81 — 1983-84). (Paragraphs 2.10 and 2.12)

4. Mobilisation of savings and the deployment of these resources among different sectors of the economy according to Plan priorities, are key elements in the process of developmental planning. Although the financing of the successive Plans was facilitated by greater mobilisation of savings, there has been a disconcerting inflationary trend in the economy over the years. The First Plan witnessed a moderate decline in prices. Inflationary pressures started building up from the commencement of the Second Five Year Plan. (Paragraph 2.15 and 2.17)

5. The management of aggregate demand and supply balance has there-

fore assumed increasing importance over the years in the context of the Plan objective of growth with reasonable price stability. (Paragraph 2.18)

6. The importance of strengthening credit delivery systems of the co-operative banks and commercial banks has been recognised in the successive Plans, particularly since the major segment of the commercial banking system was brought under the public sector in 1969. (Paragraph 2.19)

7. As an increasingly important role was assigned to the public sector in stepping up the economic activity in the country, it became necessary to ensure that the public sector gained commensurate command over the resources of the economy. Apart from the higher ratio of taxes to national income, structural and organisational changes in the financial system have also enabled the public sector to draw upon the country's financial resources in an increasing measure. (Paragraph 2.21)

8. Government, however, has been incurring deficits which suggests that its access to saving falls short of its expenditures, and is not keeping pace with the growing demands on government which are reflected in the rising volume of subsidies, buffer stocking operations, as also developmental expenditures. (Paragraph 2.23)

9. The increased recourse to deficit financing is a disconcerting development and it is necessary to ensure that deficit financing, measured in terms of recourse to credit from the Reserve Bank, does not exceed safe limits. This implies that Plan expenditures should be financed in a non-inflationary manner by tapping the savings of the public in greater measure than in the past, apart from realising higher savings from the public sector enterprises and improving efficiency in revenue gathering and expenditure functions. Only then the process of planned economic development can maintain its momentum and also ensure that its benefits reach the target groups without being eroded by inflation. (Paragraph 2.23)

10. The level of marketable debt of the Government of India at Rs. 43,294 crores at the end of March 1984 indicated a five-fold increase over the level in 1971 implying an annual average growth of Rs. 2,795 crores. In the period 1977-78 through 1983-84 the average net amount raised annually was as much as Rs. 4,265 crores as against the average net amount of Rs. 1,080 crores in the period 1971-72 through 1976-77. (Paragraph 3.4)

11. The relative share of State Governments in marketable debt out-

standing which was 15.1 per cent in March 1971 declined to 9.1 per cent in March 1984. (Paragraph 3.5)

12. As a proportion of gross domestic product at current market prices the outstanding amount of Central Government securities including Treasury Bills was around 17-20 per cent between 1970-71 and 1976-77, but then onwards it rose to reach a level of 25.1 per cent by March 1983. (Paragraph 3.6)

13. Securities with a maturity of less than five years formed about one-third of the total securities outstanding at the beginning of the Seventies. Since 1973-74 their share showed a persistent fall and was at a low of 11.9 per cent in 1980-81. Correspondingly, the proportion of long-term securities i.e., those with maturity of over 10 years, increased markedly from 43 per cent in 1970-71 to 72 per cent in 1983-84. The share of medium-term securities did not reveal any perceptible change barring a temporary spurt in the middle of the Seventies. (Paragraph 3.7)

14. The coupon rates and yield rates on government securities have been out of alignment with other rates in the economy over the last decade. The policy in recent years has therefore been to gradually raise the interest rates on government securities. (Paragraph 3.9)

15. The market for government securities is narrow and the major investors are commercial banks, insurance companies, provident funds and other trust funds. Investment by households in government securities has been negligible. The Reserve Bank's share in the total outstanding Central Government securities fell from 36 per cent in March 1971 to 20 per cent in March 1979 but rose to 28 per cent by March 1983. (Paragraphs 3.10 and 3.12)

16. An aspect of the market borrowing programme of the government that needs to be highlighted is that over the years the Reserve Bank has been called upon to take up a sizeable proportion of the new issues. The Reserve Bank's subscription to the net loans floated formed about 64 per cent in 1981-82 as per latest available data. (Paragraph 3.13)

17. The Reserve Bank of India itself holds over 90 per cent of outstand-

ing Treasury Bills. This is because purchasers of Treasury Bills do not hold them till maturity in view of their very low yield. (Paragraph 3.19)

18. The process of funding of Treasury Bills by the government was introduced in 1958-59, with the funding of Rs. 300 crores of *ad hoc* Treasury Bills. Funding in subsequent years has not been of any significant order except in 1981-82 when *ad hoc* Treasury Bills of the face value of Rs. 3,500 crores were funded into special securities issued in favour of the Reserve Bank. Since then no further funding has been resorted to. (Paragraph 3.19)

19. As a consequence of the sizeable increase in the volume of borrowings, the total interest liability of the Central Government escalated from Rs. 604 crores in 1970-71 to Rs. 4,850 crores in 1983-84. (Paragraph 3.23)

20. The total gross receipts from small savings schemes increased from Rs. 785 crores in 1970-71 to Rs. 5,329 crores in 1983-84. (Paragraph 3.24)

21. The rate of interest offered on small savings instruments is higher not only with reference to the coupon rates on government securities but in relation to rates on other comparable instruments like bank deposits. Experience in the matter of attracting savings to small savings media provides an useful indicator of the relevance of interest rates in the mobilisation of resources. (Paragraphs 3.25)

22. State Governments generally issue securities with a maturity of 10 years to 15 years and the coupon rates on securities were slightly higher than those on comparable maturities floated by the Central Government until 1981-82. The present policy regarding the terms of borrowings advocates the same coupon rate on securities of comparable maturity. (Paragraph 3.27)

23. The terms and conditions such as the rate of interest, issue prices, maturity period and underwriting commissions for floatation of market loans of the Central and the State Governments and the government-sponsored institutions are finalised by the Reserve Bank in consultation with the Government of India at the beginning of the financial year. All the loans are currently issued at par. The Reserve Bank manages issue of loans floated by the Central Government and the State Governments. (Paragraph 3.33)

24. The Reserve Bank has no special representative in the market and

makes use of the services of stock brokers. It maintains an approved list of brokers and the brokers are selected on the basis of reputation, financial standing, volume of business etc. Commercial banks are, however, not permitted to use the services of brokers for subscription to new issues of government loans and have to tender their applications directly to the Reserve Bank. The loans floated by the Central and the State Governments are not underwritten. (Paragraph 3.34)

25. Payment of interest on promissory notes on due dates to the holder involves a heavy load of work on the Public Debt Office on interest payment dates. A possible solution to this problem which could be examined by the Reserve Bank is payment of interest on the basis of coupons attached to these notes without insisting on presentation of these notes for drawing interest. (Paragraph 3.37)

26. The first major initiative needed to develop Treasury Bills as a monetary instrument is to move away from a fixed artificially low discount rate to a flexible rate that would make the discount rate on Treasury Bills a pace-setter for other rates in the money market. A flexible Treasury Bill rate would enable the monetary authorities to exercise control over money market operations. A flexible rate would also enable the banks to adjust to changes in their short-term liquidity through the purchase and sale of Treasury Bills. (Paragraph 3.40)

27. Reserve Bank accommodation to the commercial banks could also be provided in the form of rediscounting of Treasury Bills. This would go a long way in fostering the market for Treasury Bills. (Paragraph 3.41)

28. Considerable promotional work will have to be done by the Reserve Bank in the present context of a virtually dormant gilt-edged market, and development of intermediaries such as brokers of securities would constitute an initial and essential step in this direction. (Paragraph 3.42)

29. Government may experiment in a limited way with an alternative proposal that has been made with respect to the floatation of government securities. It has been suggested that government may issue securities without any coupon rate of interest, but at an appropriate discount depending upon the maturity period and the implicit yield. This will have the advantage of doing away with all the procedural and clerical work involved in calculating payment of interest on securities every six months and deducting at source income-tax thereon. This will also do away with the cumbersome practice of calculating interest and tax for preparing a sale or purchase note while selling or purchasing government securities in

the market. Banks and insurance companies may be statutorily required to value such securities which carry no coupon rate of interest at the prevailing market value. (Paragraphs 3.43 and 3.45)

30. The share of the household sector in the total gross domestic saving was 73.7 per cent in 1950-51, and it continues to occupy a predominant position with a share of 74.3 per cent in 1983-84; saving of the public sector showed fluctuations over the period and was 18.0 per cent in 1983-84. The share of the private corporate sector was 7.7 per cent in 1983-84. (Paragraph 4.5)

31. The proportion of saving in the form of financial assets to total household saving increased from 36 per cent during 1951-56 to 56 per cent during 1961-66, and was 54.1 per cent during 1983-84. The reasons for the share of financial assets in total household saving being not much different in 1983-84 as compared to 1961-66 requires to be examined closely. One would expect that the results achieved through planned development and the considerable strengthening of the institutional structure should have contributed to a steady rise in the share of financial savings by households in their total savings. Evidently this process has been arrested around the mid-Sixties, despite the considerable progress in the banking sector since the early Seventies. (Paragraph 4.7)

32. The increase in holdings of currency and deposits accounted for a share of 29.6 per cent of the gross financial savings of the household sector during 1951-56. This share increased to 52.9 per cent during 1961-66, and with some fluctuations in the following years stood at 52.2 per cent during 1980-84. (Paragraph 4.10)

33. Financial claims as a ratio to physical capital formation (Financial Inter-relations Ratio) have shown an almost steady rise over the years. The FIR was 0.63 during 1951-56, 0.98 during 1961-66, and 1.25 during 1974-79. The FIR was 1.40 during the period 1980-82. The rising ratio indicates a faster growth in the financial claims issued as compared to the growth in physical investment. The trends in the FIR observed in India are perhaps supportive of the hypothesis that during the course of economic development, the financial structure of an economy grows more rapidly than the national income during the early phases of development. The rise in the FIR was a result of an increase in primary issues as also in secondary issues. (Paragraph 4.18)

34. The institutionalisation of saving has made more progress in respect of short-term financial assets particularly monetary assets, than long-term assets, like securities. (Paragraph 4.22)

35. Using the wholesale price index as a deflator, the assets of financial institutions at 1970-71 prices grew at an annual compound rate of 8.2 per cent during 1951-61, at 5.6 per cent during 1961-71 and at 6.3 per cent during 1971-81.(Paragraph 4.28)

36. The much faster growth of financial assets compared to the growth of national income over these years points to a gradual financial deepening of the economy.(Paragraph 4.28)

37. Scheduled commercial banks have witnessed rapid growth since 1969. Their deposits as a percentage of national income rose from 15 per cent in 1969 to 38 per cent in 1984; the share of priority sector advances in gross bank credit moved up from 14 per cent to 36.7 per cent, with a concomitant fall in the substantially large proportion of credit earlier enjoyed by the medium and large industry and trade. The average size of population per bank branch improved from 65,000 to 15,000. Further, the number of rural branches in the total number of bank branches stood higher at 56 per cent as compared with 22 per cent in 1969. (Paragraph 5.3)

38. Traditionally, co-operative credit has been assigned a significant place in the policies governing the provision of rural finance, and the co-operative organisations continue to play a vital role in the Indian monetary system. The total number of all types of co-operative banks and credit societies as at the end of June 1980 (the latest data available relate to that period) stood at over 1,22,000 with an aggregate membership of 790 lakhs and aggregate working capital of about Rs. 15,000 crores. The total deposits mobilised by the co-operative credit system as at the end of June 1980 amounted to Rs. 5,000 crores.(Paragraph 5.4)

39. In the field of rural credit, the operations of co-operatives continue to be sizeable and they are an important constituent of the multi-agency system which has been evolved to meet the growing credit requirements of the rural sector. (Paragraph 5.6)

40. Total deposits with scheduled commercial banks aggregating Rs. 63,852 crores at the end of June 1984 represented a spectacular increase over the level of Rs. 4,646 crores at the end of June 1969. Similarly, there has been a manifold increase in the number of accounts : the number

of accounts stood at 145 million at the end of June 1981 as against over 38 million in June 1973. (Paragraph 5.7)

41. Deposits mobilised by rural bank branches constituted about 13 per cent of the total deposits in 1981 as against 3 per cent in 1969. (Paragraph 5.7)

42. Deposits with a maturity of over 5 years constituted about 61.8 per cent of the total term deposits; the proportion was only 6.2 per cent in 1969. Households' preference for deposits of longer maturity which carry the highest interest rate offered on bank deposits is a factor which affects the cost structure of banks. (Paragraph 5.7)

43. Between 1973 and 1983, the credit-deposit ratio of rural branches improved from 47.2 per cent to 59.9 per cent. It should however be noted that the credit-deposit ratio often does not serve as a reliable indicator of the trends in mobilisation of deposits and deployment of credit in a particular region/area. This is because (a) the ratio does not take into account banks' investment in the securities of State Governments, state level institutions etc. (b) credit might have been sanctioned by offices of banks in metropolitan areas but used in rural/urban area, or credit sanctioned in one State, might have been deployed in another State and (c) sometimes the amounts of both deposits accretion and credit expansion could be very small but the ratio could be high. (Paragraphs 5.9 and 5.10)

44. Bank finance extended to the priority sector rose from Rs. 1,208 crores to Rs. 14,834 crores between 1972 and 1984. (Paragraph 5.12)

45. In the post-nationalisation period the amount of term loans provided by banks particularly in favour of small industries and agriculture showed a substantial increase, with the result that the share of term loans in total bank credit showed a persistently increasing trend from around 12 per cent in the early Seventies to about 24 per cent in 1981. The total number of term loan accounts as at the end of December 1981 was 651,671 or 41 per cent of the total number of accounts and the amount of term loans outstanding aggregated Rs. 5,790 crores. (Paragraph 5.15)

46. While bank credit has grown substantially over the past fifteen

years, a matter of some concern is the increase in the level of credit outstanding in respect of sick industrial units, and increase in overdues in the case of rural credit. The outstanding credit to sick industrial units rose considerably from Rs. 956 crores in 1978 to Rs. 1,913 rores in 1983.The percentage share of credit to sick industrial units in total bank credit to the industrial sector worked out to about 14 per cent as at end June 1983. The latest available data pertaining to recovery of direct agricultural advances of scheduled commercial banks reveal that the percentage of recovery to demand as at end June 1982 was 52.2. (Paragraph 5.16 and 5.17)

47. The slower growth of earnings of banks as compared to total business and working funds could partly be attributed to rising proportion of low yielding assets such as investments in government securities, food credit, and priority sector advances during 1975-80. The rising proportion of high cost deposits and also increase in operating cost contributed to faster growth of expenses as compared to that of earnings. (Paragraph 5.42)

48. The concept of operational efficiency of a commercial bank in India is associated with such diverse aspects of its operations as cost effectiveness, profitability, customer services, priority sector lending, mobilisation of deposits and deployment of credit in the rural and backward regions and so on. Operational efficiency in banking has attained a wider connotation. Precisely for this reason, a generally acceptable definition of the concept, and selection of appropriate indicators are beset with difficulties. Nevertheless improvement in productivity in all aspects of banking operations has to be pursued by banks as an important management objective as it vitally affects the efficiency of the monetary system. (Paragraph 5.50)

49. During the period 1969-84 the banking systemin India witnessed a phenomenal geographical expansion and tremendous functional diversification. The number of bank customers, transactions and inter bank transfers increased enormously. As at the end of 1980, the banking system had more than ten million customers, with an estimated three million transactions and one million inter-branch transfers per day. These rapid developments have placed a severe strain on the organisational resources of banks. (Paragraph 5.51)

50. The three working groups of the Reserve Bank of India on (i) Accounting Procedures and Maintenance of Branch Level Records,(ii) Review of Working of Lead Bank Schemes and (iii) Role of Banks in Implementation of New Twenty Point Programme arrived at the conclusion that mechanisation was inevitable for developing a speedy information

system. The recent report of the Committee on Mechanisation in Banking Industry contains an in-depth study of the issues relating to mechanisation. (Paragraph 5.53)

51. The quantum and the order of increase in resources mobilised by the non-banking companies which amounted to about 1.4 per cent in relation to GDP cannot be considered to be significant as compared with the deposits mobilised by banks which were of the order of 34 per cent of GDP in 1982-83. (Paragraph 5.63)

52. The main argument in favour of the finance corporations is that they operate in a market outside the banking system to the convenience of certain borrowers and savers. The regulation of their deposit and lending rates will destroy the *raison d'etre* of such corporations which are in the nature of para-banking agencies. Regulation should, therefore, seek to curb that part of their activities which are not in conformity with official credit policy but not that which genuinely helps trade. (Paragraph 5.67)

53. About one-half of the hire purchase institutions is in the corporate sector while the rest are in the non-corporate sector. They provide an useful service to industrial units by facilitating sale of consumer goods and to transport operators. The hire purchase finance institutions in the non-corporate sector need to be encouraged by policy measures to become companies. (Paragraph 5.68)

54. A system of licensing appears to be essential to protect the interest of depositors of the non-banking financial intermediaries, and a suitable cut-off point, taking into account their large numbers, and administrative considerations, may be laid down in regard to the level of their business beyond which they will be under a legal obligation to obtain a licence. (Paragraph 5.69)

55. It is found that the demand liability portion of savings deposits, which corresponds to transactions balances, increased from 64.5 per cent in 1961 to 86.0 per cent in 1975 suggesting that savings deposits increasingly performed the function otherwise performed by currency. An alternative approach to the bifurcation of savings deposits was adopted in 1981 and data on money supply starting from March 1978 are now available on the basis of this new approach. (Paragraph 6.7)

56. The essence of the present method of bifurcating savings deposits into the demand liability and time liability portions lies in identifying a portion of these deposits on which interest is actually paid and treating this portion as time deposits, the balance being treated as demand deposits. This

method of classification has resulted in a break in the M_1 series inasmuch as a sizeable portion of savings deposits were transferred from demand deposits to the category of time deposits. Apart from the statistical problem of loss of continuity in the M_1 series, this method of classification requires further examination in the light of the recent partial deregulation of interest rates payable on deposits of less than 1 year maturity. (Paragraph 6.7)

57. The currency-deposit ratio in India has steadily fallen from 1.53 in March 1951 to 0.30 in March 1984, deposits in this computation representing aggregate deposits. This steep fall highlights the growth of deposits in the economy resulting from the rapid growth of banking facilities. The money multiplier has, therefore, risen from 1.54 in March 1951 to 2.98 in March 1984. (Paragraph 6.7)

58. In view of this observed stability in the level of cash on hand with banks, the changes in the deposit money multiplier are essentially brought about by changes in the cash reserve stipulations from time to time. As of March 1984, the ratio of deposit money to bank reserves was 7.68 as compared to 9.14 in March 1951. (Paragraph 6.7)

59. A look at the sources of reserve money in recent years will show that RBI's net credit to government was the principal source of reserve money. Net RBI credit to government as a proportion of reserve money was 83 per cent in March 1971 and 85 per cent in March 1981 and rose to 92 per cent in March 1984.(Paragraph 6.21)

60. Reserve Bank credit to commercial sector grew at an annual average of Rs. 117 crores during the Seventies against the average annual increase of Rs. 7 crores in the Sixties and less than one crore of rupees per year on the average in the Fifties. This higher volume of credit to commercial sector was mainly occasioned by the growth of development banks. (Paragraph 6.22)

61. A study of the relationship between reserve money and money stock must take into account the impact of changes in the CRR which directly affect the ratio of money stock to reserve money. Empirical studies of the multiplier accordingly must incorporate this impact explicitly by taking CRR as an additional variable or adjust the reserve base to an uniform cash reserve ratio. The impact of changes in reserve requirements can thus be captured either in the money multiplier or in reserve money. (Paragraph 6.24)

62. The observed variability of the money multiplier may lead one to

assert that the relationship between reserve money and money stock is not strong. The money multiplier is, no doubt, affected by changes in the public's preference for currency but the variability of the observed multiplier is also due to statistical and other factors which must be isolated in order to understand the basic relationship. It is in fact influenced by several factors resulting in a lagged relationship between changes in reserve money and changes in money stock. (Paragraph 6.24)

63. If due allowance is made for the influence of the above statistical factors, the relationship between reserve money and money stock in India can be described as quite strong in the Seventies on the basis of the findings of a recent study. (Paragraph 6.25)

64. The sources of reserve money, and the factors influencing the behaviour of the money multiplier require, therefore, to be studied closely in order to explain changes in money supply. Looking at the sources of reserve money it is evident that such a study should necessarily cover an analysis of the wide range of developments influencing the sources of reserve money, and the behaviour of the money multiplier. Of these, the government's borrowing from the Reserve Bank is probably the most important in the Indian context. (Paragraph 6.26)

65. The performance of the agricultural sector has a pervasive influence on the growth of the economy as a whole and particularly on industrial production and the price situation. While the dependence of certain industries on supplies of agricultural raw materials is well known, the demand emanating from the agricultural sector has also been found to be of particular importance to a wide spectrum of industries. (Paragraph 7.2)

66. The secondary sector which mainly comprises manufacturing and construction constituted 20 per cent of GDP in 1970-71 and its share has since increased only slightly over that level. The tertiary sector's contribution has been steadily increasing over the years, its contribution having risen from 30.8 per cent in 1970-71 to 38.2 per cent in 1983-84. (Paragraph 7.3)

67. Agricultural production which increased at an average of 3.4 per cent per annum during 1970-71–1983-84 has shown wide fluctuations from year to year. The wide year to year fluctuations in the output of non-food agricultural commodities have had their impact on the growth of manufacturing output in which agro-based industries have a share of about 33 per cent. The overall index of industrial production during 1970-71–1983-84 rose at an average annual rate of 4.7 per cent. (Paragraph 7.4)

68. The rise in prices in the case of primary articles was 204 per cent over the base year 1970-71 i.e. an increase of 9.9 per cent per annum. During this period, the prices of primary articles rose by more than 25 per cent per year in two years. The prices in respect of fuel, power, light and lubricants rose by 390 per cent by 1983-84 over the base year 1970-71 i.e. at an average annual rate of 13.7 per cent. (Paragraph 7.8 and 7.9)

69. The inflation rate in manufactured products was the least with their prices increasing at the rate of 8.9 per cent per annum during 1971-72–1983-84. (Paragraph 7.10)

70. The rate of change in the price level as measured by annual changes in the wholesale price index during 1961-62–1970-71 was moderate at 6.2 per cent, and during 1971-72–1983-84 it was markedly higher at 9.5 per cent per annum. During the Fifties, the inflation rate in India as compared to the OECD countries was not very much higher. Japan had a higher rate of inflation than India. During the Sixties except for Iceland all the OECD countries had a lower inflation rate compared to India's 6.1 per cent. During the Seventies we find that a majority of the OECD countries experienced a sharper increase in the price level than the 7.4 per cent rate of inflation in India. Germany and Switzerland, however, had lower inflation rate of only 5.0 per cent followed by Austria (6.1 per cent) and Luxembourg (6.5 per cent). U.S.A. had an inflation rate of 7.1 per cent. (Paragraphs 7.16 and 7.17)

71. The average annual rate of inflation measured in terms of the consumer price index was 11 per cent in India during the period 1980-83. Out of the twenty four OECD countries, fourteen countries had inflation rates lower than India during this period and the rate of inflation was much lower at only 4.4 per cent in Japan and 4.9 per cent in West Germany while in the U.S.A. the inflation rate was 8.3 per cent during this period. (Paragraph 7.18)

72. The single most important factor influencing the conduct of monetary policy since 1970 is the phenomenal increase in reserve money. The major component of this increase was the increase in Reserve Bank credit to government on which the central bank had little control. In view of this, the only feasible approach to the control of monetary expansion was to influence the value of the money multiplier by raising the Cash Reserve Ratio. This was done repeatedly and the rise in the average money multiplier was more or less arrested after the mid-Seventies and stabilised at a level slightly below 3.0. This achievement fell far short of the requirements of the situation in several years during the period under review when a drastic reduction in the rate of growth of M_3 was called for. (Paragraphs 8.7 and 8.9)

73. During the period since 1970 when drastic monetary control measures were the need of the hour both Reserve Bank and the government have closely co-ordinated their actions and have thereby achieved the desired results. Instances of such co-ordination have demonstrated the powerful impact of such concerted action by the Reserve Bank and the government and serve to stress the importance of close consultations between them in order to develop common perceptions of the emerging trends in the economy and the desirable lines of policy action. (Paragraph 8.11)

74. The expansion in M_3 by 37 per cent over 1971-73 set the stage for a steep rise in prices in 1973-74. The build up of inflationary pressures over 1971-73 seems to have been recognised by the central bank only in May 1973 as evidenced by the timing of corrective monetary policy action. (Paragraphs 8.14 and 8.15)

75. Weak and delayed monetary control measures in the first half of 1973-74 allowed prices to rise at an annualised rate of 24 per cent and at the annualised rate of 30.8 per cent between September 1973 and March 1974. (Paragraph 8.15)

76. The substantial expansion of bank credit during the second half of 1973-74 and 1974-75 showed that in periods of inflation the lending rates of banks did not have much of an impact on demand for bank credit and hence the CRR weapon should have been used with greater force than was actually the case. (Paragraph 8.18)

77. Changes in regard to refinance facilities effected in June 1978 virtually brought to an end their role as an additional monetary control measure in subsequent periods. (Paragraph 8.24)

78. Banks were required to apply an across the board cut on the drawing power against credit limits to the extent of 20 per cent of the peak level utilised during the two year period ending June 1979. This sudden reduction in effective drawing power to 80 per cent of the credit utilised in a past period was an unusual measure indeed. Though it was probably prompted by the certainty of a most severe drought affecting the kharif crop, and its aftermath, the measure could only be inequitous in operation. (Paragraph 8.31)

79. The powerful psychological impact of expectations regarding a widespread crop failure on trade and business as also on the general public can be gauged by the events as they unfolded during the first half of 1979-80. The second oil shock further aggravated the situation and inflationary expectations got a strong hold on the economic agents.(Paragraph 8.33)

80. For the first time in five years, the trend in net foreign exchange assets of the Reserve Bank was reversed in 1979-80 when there was a decline of Rs. 12 crores. This decline continued in later years till the net foreign exchange assets rose in 1984-85.(Paragraph 8.35)

81. Considering that the rise in the wholesale price index on the basis of average of months was 18.2 per cent in 1980-81 as against 17.1 per cent in the previous year, the timing of the decision to withdraw the additional cash reserve requirement in October 1980 is open to some criticism, particularly since the large fiscal deficit announced at the beginning of the year would have already signalled a steep increase in Reserve Bank credit to government with consequent pressures on monetary expansion which could only be contained by holding a tight rein on the money multiplier.(Paragraph 8.39)

82. The increase in CRR towards the end of July from 6 per cent to 6.5 per cent and further to 7 per cent in August appear to have been well timed to prevent a repetition of the kind of monetary expansion observed in the second half of the previous year.(Paragraph 8.41)

83. Having let bank credit expand at an unusually high rate in the first half of 1981-82 the monetary authorities had to apply a sharp brake on the expansion in the second half to contain the overall growth in bank credit. This they accomplished though not without some undesirable consequences for certain sectors.(Paragraph 8.41)

84. The phased increase in CRR starting November 1981 which was announced in advance was a departure from previous practice, and probably had an additional impact by being perceived by banks and their clients as an indication of the determination of the central bank to regulate monetary expansion within narrow limits. Its impact on inflationary expectations was also probably significant.(Paragraph 8.43)

85. The relaxation of CRR effected in June 1982 points to the confidence the central bank had in its ability to restrain non-food bank credit expansion by adjusting the threshold for food credit refinance.(Paragraph 8.45)

86. The fall in foodgrains output in 1982-83 was probably instrumental in giving a boost to inflationary pressures which resulted in a price rise of 16 per cent on an annualised basis during the first half of 1983-84, despite strong monetary control measures.(Paragraph 8.48)

87. It appears that a strict vigil over monetary expansion in the first half of the year is essential in order to retain some manoeuvrability in the sec-

ond half of the year to determine the rate of monetary expansion suited to the rate of growth in output and emerging price trends as signalled by the kharif crop.(Paragraph 8.50)

88. The central bank also has a difficult task of determining the timing of its regulatory measures on the basis of its experience in regard to the lags involved. As the banking system has grown considerably over the years the cost of a delayed decision can be considerable. Similarly, while monetary brakes are to be applied it is necessary to start early and in a phased manner as the impact of regulatory measures cannot be allowed to be so drastic as to cause unintended hardship to specific sectors of the economy.(Paragraph 8.50)

89. The inter-action between money, output and prices is very often summarised in one equation which takes the form of the demand function for real money balances on the postulate that the causation runs from real income to money. As the process of money creation is simultaneously a process of credit creation, it is necessary also to look upon the problem from the credit side since an output increase may require a certain amount of increase in credit. (Paragraphs 9.3 to 9.6)

90. The extent of increase in the price level associated with an increase in output and money will depend on the elasticity of output with respect to credit and the elasticity of price with respect to money as well as output. Obviously these elasticities themselves depend upon the structure of production and the flexibility of supply responses and can change with time. (Paragraph 9.7)

91. An important area of concern to the monetary authority is the determination of the rate of growth of money supply, taking into account the inter-relationship between money, output and prices. In order to be acceptable to the monetary authority, the rate of growth in money supply should be in confirmity with the desired rate of growth in output and constrain the price increase to an acceptable level. From the operational point of view, without going into causation, it may be possible for the monetary authority to use such an equation to regulate the supply of money. (Paragraph 9.9)

92. Looking at the growth of money stock from the supply side, the relation between money stock, on the one hand, and reserve money and the money multiplier on the other hand needs to be considered. (Paragraph 9.11)

93. The currency-deposit ratio has declined over the past years and led to an increase in the value of the money multiplier for M_3. Further significant

decline in the currency-deposit ratio in the foreseeable future may not be forthcoming and consequently determining the acceptable rate of growth of money supply would tantamount to determining the growth of reserve money adjusted for changes in the reserve ratio. (Paragraphs 9.12 to 9.14)

94. The functioning of the monetary system must necessarily be in consonance with the national development strategy as articulated in the successive Five Year Plans. The monetary system should, therefore, seek to perform the following tasks:

(a) mobilising the savings of the community and enlarging the financial savings pool.
(b) promoting efficiency in the allocation of the savings of the community to relatively more productive purposes in accordance with national economic goals.
(c) enabling the resource needs of the major 'entrepreneur' in the country, viz., the government, to be met in adequate measure.
(d) promoting price stability.
(e) promoting an efficient payments system. (Paragraph 9.16)

95. It is essential to ensure that there is no mis-match between the responsibility of the central bank, i.e. the RBI, to supervise and control the functioning of the monetary system on the one hand, and its authority to do so on the other.(Paragraph 9.17)

96. The strong inflationary pressures witnessed in the Seventies have focused attention on the imperative need to pursue developmental strategies in a framework of price stability. (Paragraph 9.18)

97. The importance of ensuring that developmental expenditures are more directly linked to the creation of additional output than heretofore and are financed in a non-inflationary manner needs to be recognised. (Paragraph 9.19)

98. In order to maintain a viable balance of payments position, it is necessary to ensure that the domestic price level is not allowed to rise unduly, particularly since our major trading partners have had notable success in recent years in achieving price stability. (Paragraph 9.21)

99. It would be desirable, in the Indian context, to assign to the monetary authority a major role in promoting price stability, and also to accord price stability a dominant position in the spectrum of objectives pursued by the monetary authority. (Paragraph 9.23)

100. Pursuit of price stability in the broadest sense as the dominant objective by the monetary authority consistent with the other goals of national socio-economic policy as embodied in the Five Year Plans should provide the basic frame for the conduct of monetary policy in a developing economy like that of India. (Paragraph 9.25)

101. The contribution of monetary policy to the control of inflationary pressures largely lies in the area of aggregate demand management and in facilitating allocation and effective utilisation of credit in relatively more productive avenues. (Paragraph 9.27)

102. In India, the growth of high powered money or reserve money has been largely the result of increase in Reserve Bank credit to government. Any measure to check reserve money growth and hence money supply would, therefore, evidently impinge on the government's freedom to take recourse to central bank accommodation. (Paragraph 9.28)

103. A feasible approach to evolving a policy framework for ensuring a desired rate of growth of government expenditure as well as a desired rate of growth of reserve money and money supply involves a certain degree of co-ordination between government and the Reserve Bank in evolving and implementing agreed policies. Such co-ordination is essential and also feasible. (Paragraph 9.32)

104. The objective of growth with social justice can be achieved in the context of reasonable price stability only when the compulsions of demand management are adequately reflected in the level of the government's fiscal deficit financed by RBI. (Paragraph 9.37)

105. There appears to be considerable scope for government to tap the savings of the public through an appropriate interest rate structure and offer of a wider spectrum of savings instruments with attractive features. This will have the desirable consequence of lowering the rate of expansion in reserve money and money supply associated with a given level of borrowing by the government. (Paragraph 9.38)

106. An unambiguous, and economically meaningful measure of the monetary impact of fiscal operations is provided by the change in the Reserve Bank credit to government.(Paragraph 9.40)

107. It is safe to assume that the public will gradually increase its subscription to government securities carrying coupon rates (explicit or implicit) which are higher than the present levels by an average of about 3

per cent per annum particularly if the securities are available more or less throughout the year. (Paragraph 9.53)

108. Initially interest costs will increase as successive tranches of government borrowing carry the higher coupon rates but the net impact on the Government Budget need not be large in the long run to the extent that relative price stability is achieved. Indeed this should be the outcome if the monetary system is suitably restructured. (Paragraph 9.54)

109. The increased holding of Treasury Bills and government securities by the public would imply, other things being equal, a slower growth in bank deposits and correspondingly in bank credit reflecting the slower expansion of reserve money. Maintenance of desired levels of bank credit to the non-government sector can be achieved through a less than compensating increase in reserve money as compared to the reduction in reserve money occasioned by the contraction in Reserve Bank credit to government (net), if the compensating reserve money expansion is in the form of RBI assistance to banks. (Paragraphs 9.57 and 9.58)

110. The arrangement referred to in Paragraph 109 above has the considerable merit of subjecting government borrowings at least partly to the operation of economic forces, and of providing the Reserve Bank with the opportunity of not only providing reserve money to the banks, but also of *withdrawing* it, as circumstances warrant. (Paragraph 9.60)

111. The complex nature of the administered interest rate structure has also resulted in reducing the scope for effecting counter cyclical variations in interest rates. (Paragraph 9.65)

112. Interest rates applicable to a substantial portion of a bank's assets portfolio are either lower than or barely above its cost of funds. This is not a healthy situation. (Paragraph 9.65)

113. The implementation of projects with poor rates of return needs to be discouraged through a policy of maintaining real rates of interest at realistic levels by eliminating or reducing the element of concessionality in the interest rates charged on long term loans. (Paragraph 9.66)

114. We, therefore, believe that while the policy of relying on monetary budgeting and credit budgeting to achieve desired sectoral credit allocation should continue, there does appear to be a strong case for greater reliance on the interest rate instrument with a view to promoting the effective use of credit and in short-term monetary management. We believe that the quantitative controls can be more effective if they are supported by a suitable

interest rate policy which incorporates a subsidiary yet crucial role for price rationing in the disbursement of credit. (Paragraph 9.69)

115. The pre-occupation with concessional interest rates has, unfortunately, deflected attention away from the much more potent instrument of social justice which takes the form of adequate and timely availability of credit to the neglected sectors, particularly in the rural areas. We would, therefore, like to recommend strengthening of the credit delivery system with a view to provide adequate and timely credit to target groups covered under priority sector lending, and the motivation to do so should not be allowed to be reduced through any undue emphasis placed on grant of credit at concessional interest rates, since such an emphasis could well prove to be counter productive. As such only a very selective approach to the use of concessional interest rates seems to be warranted in contrast to the excessive reliance at present on concessional interest rates as a redistributive device. (Paragraph 9.72)

116. A substantial volume of credit is pre-empted by government at relatively low interest rates. The complex operations of government can be made more efficient if a device like raising the cost of borrowings is more effectively and widely used. (Paragraph 9.75)

117. Considering the under-utilisation of capacity in several industries, the utmost importance should be given to ensuring that creation of additional capacity is not induced by availability of funds at concessional interest rates or fiscal incentives or by anticipation of protected markets. (Paragraph 9.76)

118. Facilitating recourse to bill finance is another desirable method of promoting effective use of credit. (Paragraph 9.78)

119. The supervision of the end-use of credit by banks is rendered more difficult by the widespread use of cash credit as a means of providing credit for working capital. (Paragraph 9.79)

120. The restructured monetary system which we have outlined provides the monetary authority with instruments which have the necessary strength, flexibility, and precision to accomplish the task of monetary management in the short and medium term. (Paragraph 9.82)

121. In implementing the suggested restructuring of the monetary system it will however be necessary to carefully consider the problems of transition from the present system. (Paragraph 9.83)

122. While the basic philosophy of the restructured system lies in affording greater flexibility to monetary and related institutions at the micro level, the need to co-ordinate their activities in the interests of achieving national objectives of socio-economic policy remains, and the latter should be a major concern of the monetary authority. It is in this context that the need for the monetary authority to embark on monetary targeting in the formal sense acquires importance. (Paragraphs 9.83 and 9.84)

123. Formulation of monetary policy with M_3 as the monetary variable to be targeted becomes a feasible proposition in the restructured monetary system envisaged by us. (Paragraph 9.85)

124. The observed relationships between money, output and prices in India over the past two decades suggest a basis for determining the range of targets for monetary growth. What we have in view is not mechanistic monetary targeting un-influenced by the impact of developments in the real sector, but what we might characterise as monetary targeting with feedback which enables changes in the targets to be made in the light of emerging trends in output and prices. The setting of the monetary target has to be in the form of a range rather than a specific magnitude of monetary expansion. (Paragraph 9.88)

125. We therefore recommend that the Reserve Bank of India adopt monetary targeting as an important monetary policy tool, subject to the cautions sounded by us and this would bind the Reserve Bank and the Government of India in a common effort to achieve the desired rate of growth in money supply, as in the Indian situation control on monetary growth is impossible without the full support and understanding of the government. (Paragraph 9.88)

126. It would be necessary to have an aggregate monetary budget annually as also for the period covered by the Five Year Plans in order that, over the medium term, reasonable co-ordination between the production and credit plans is achieved. (Paragraph 9.89)

127. A credit budget for the banking sector is also to be prepared as a part of the exercises on the monetary budget. The objective of the credit budget is to determine the permissible level of bank credit to commercial sector and a broad profile of the sectoral deployment of credit. (Paragraph 9.90)

128. The monetary projections are to be based both on behavioural relations for various components of money stock and exogenous factors like government budgetary operations and net foreign exchange assets. The cru-

cial behavioural relations are the demand for money and public's preference for currency vis-a-vis deposits. It should be noted that implicit in the relationship is also the link between monetary expansion and reserve money expansion. (Paragraph 9.99)

129. A monetary planning model of the type described by us would facilitate an analysis of the impact of alternative monetary policy measures and constitute an aid to formulation of monetary policy. (Paragraph 9.100)

130. The administered interest rate system has grown to be unduly complex and contains features which have reduced the ability of the system to promote the effective use of credit. (Paragraph 10.1)

131. Quantitative credit controls have come under severe stress in the absence of support from any price rationing mechanism. (Paragraph 10.1)

132. The administered interest rate system has been found to be lacking the flexibility necessary for augmenting the pool of financial savings by effecting suitable changes in the deposit rates from time to time as the low profitability of banks has made banks wary of increasing the average cost of deposits. (Paragraph 10.1)

133. Any modification of the system of administered interest rates should keep in view the considerations outlined below in paragraphs 134 to 140. (Paragraph 10.2)

134. It should be recognised that government is a major borrower and is under an obligation to pursue the objectives of planned socio-economic development of the country through successive Five Year Plans. (Paragraph 10.3)

135. The monetary system must play its part in augmenting the pool of financial savings. (Paragraph 10.4)

136. In the interest of social justice the monetary system should pay special attention to small savers. (Paragraph 10.5)

137. The reliance on the price mechanism should be in addition to and not a substitute for, quantitative controls on credit flowing from Plan priorities and the compulsions of demand management. (Paragraph 10.6)

138. Short-term interest rates could reinforce the anti-inflationary impact of monetary targeting if they are also used as a monetary management tool in fighting inflation. (Paragraph 10.7)

139. Any rationalisation of the array of concessional interest rates in the interest of administrative efficiency and as a result of an evaluation of the real cost of the lender must not ignore relevant societal concerns. (Paragraph 10.8)

140. A fair degree of regulation of interest rates is necessary so as to provide for an orderly mobilisation of financial savings for purposes of planned economic development as well as in the interest of viability of operations of banks of widely varying size in terms of deposits and advances and differing greatly in regard to the quality of their human resources. (Paragraph 10.9)

141. In our view the Treasury Bills should be developed as an active monetary instrument and should constitute the ideal short-term paper in the money market. What comes in the way of such a development is its low yield. (Paragraph 10.11)

142. It should be noted that the Treasury Bill which is a short-term financial instrument so far as the money market is concerned, is indeed a long term source of funds for the government. (Paragraph 10.12)

143. Borrowing by way of Treasury Bills should not be construed as a convenient alternative to market loans of medium or long maturity. A short term instrument cannot be used to finance essentially long-term requirements. The quantum of borrowing through the issue of Treasury Bills should truly reflect the unanticipated variation between revenues and expenditure which need not always be large. (Paragraph 10.13)

144. We recommend that the discount rate on Treasury Bills of 91 days should provide an yield which is marginally positive in real terms. This means that the nominal rate of discount would have to be higher than the expected change in the price level. Treasury Bills with a rate of discount of 4.60 per cent per annum need to be funded before new Treasury Bills are issued at revised rates of discount. (Paragraph 10.14)

145. Medium and long dated government securities need to have yields which are in keeping with the expectations of the capital market in regard to the long term movement of the price level. (Paragraph 10.15)

146. An upward revision of yields on government securities from current levels coupled with a shortening of the maturities can result in attracting funds from the capital market much above what the present captive market is able to provide. (Paragraph 10.15)

147. We recommend that the yields on government securities with maturities not exceeding 15 years be so determined as to provide on an average over the entire spectrum of new issues an yield of 2 per cent per annum in real terms.(Paragraph 10.16)

148. The primary purpose of our recommending a revision in the yield structure of government securities is to eliminate the likelihood of any significant monetisation of debt, and consequent increase in Reserve Bank credit to government beyond agreed limits. (Paragraph 10.17)

149. The revision of the yield structure of Central Government securities on the lines mentioned above would necessitate a corresponding revision in the yield structure of State Government securities, and other approved securities. (Paragraph 10.18)

150. There is a need to introduce some element of price competition among banks. The 'controlled competition' which we have in view involves an 'administered spread' between the interest rate on bank deposits with a maturity of 5 years and above, to be determined by the Reserve Bank and the basic lending rate which would serve as a floor to the non-concessional lending rates of banks.(Paragraph 10.20)

151. Taking the present structure of interest rates and bank profitability as a guide, and also taking into account our recommendations inregard to the yield structure of government and other approved securities which are relevant in the context of the SLR investment of banks, we believe a 3 percentage point spread between the maximum rate on deposits and the basic (minimum) lending rate of banks should provide an acceptable spread to the banks.(Paragraph 10.20)

152. It is desirable that the Reserve Bank determines the interest rate on bank deposits of one year maturity as also the maximum interest rate for deposits with a maturity of 5 years or more. (Paragraph 10.20)

153. We recommend that the deposit rate to be offered by banks on deposits with a maturity of 5 years or more should be such as to offer the saver a minimum positive real return of 2 per cent per annum, and the deposit rate on deposits of one year maturity should be marginally positive in real terms; these deposit rates may be determined accordingly by the Reserve Bank. (Paragraph 10.20)

154. Except for deposits with maturity of 5 years or more, the banks should be free to choose their maturity pattern of deposits.(Paragraph 10.21)

155. The absence of a ceiling rate on bank loans and advances is a desirable feature which would promote better use of credit by borrowers on the one hand and competition among banks on the other, the latter being circumscribed by the prescribed basic (minimum) lending rate. (Paragraph 10.23)

156. As regards bank lending to the priority sector, we recommend no more than two concessional rates, one being equivalent to the basic (minimum) lending rate, and the other somewhat below this rate.(Paragraph 10.25)

157. There is, however, a strong justification, in our view, for providing the small saver, who is unable to take advantage of fiscal concessions, a better deal than what he has got over the years.(Paragraph 10.29)

158. Our recommendations relating to a revision in the yield of Treasury Bills should provide banks with an acceptable short-term financial instrument and they need not depend entirely on the inter-bank call money market for meeting transient liquidity needs. Accordingly, the ceiling on the inter-bank call money rate would no longer serve any important purpose and we recommend that this ceiling should be removed.(Paragraph 10.31)

159. To sum up, the level and structure of interest rates that we have recommended here explicitly takes into account the need to make a careful assessment of inflationary expectations in the economy while determining the nominal level of certain crucial interest rates.(Paragraph 10.35)

160. There is no doubt that the importance of timely availability of credit should be reflected in the credit appraisal process at all stages, and borrowers should facilitate quick decisions by promptly providing the information called for by banks.(Paragraph 11.17)

161. Only when the borrowing concerns improve turnover of their capital, strengthen their equity base and obtain long-term funds from the capital market will they be able to maintain adequate working capital margins on a regular basis. These options are open more to the larger companies who have a good past record of operations than to others, including new companies who are not well known in the capital market. (Paragraph 11.19)

162. Bank lending essentially retains its security orientation despite the application of more sophisticated norms. The present credit appraisal procedures do not prevent utilisation of credit facilities over and above what is justified on the basis of a cash flow analysis, so long as the drawing power is not

exhausted. As the stock statements are available once a month or less frequently, and their submission can be delayed if it suits the borrower, the drawing power based on the latest available stock statement does not necessarily represent current credit requirements.(Paragraph 11.20)

163. The industrial units whose funds are locked up for long periods due to delayed payment by government agencies would perforce delay, in turn, their payments to their own suppliers, starting off a chain of events resulting in an extra burden of financing being placed on the small scale industries who generally are unable to obtain their supplies other than against cash payment.(Paragraph 11.24)

164. The introduction of the system of canalised items has removed from the private sector trade an important source of speculative activity, and at the same time provided the public sector corporations in the trade sector considerable power in the market to curb profiteering by the private sector trade.(Paragraph 11.28)

165. The setting up of export houses in the corporate sector is another development in the trade sector which deserves encouragement and working capital finance from banks on par with industry. Similar is the case with marketing of the production of small units.(Paragraph 11.30)

166. A beginning needs to be made in removing the misconception that trade is a low priority sector for bank finance as compared to industry in the present stage of economic development of the country.(Paragraph 11.33)

167. The cash credit system, in our view, suffers from two serious drawbacks which have important implications for the working of the monetary system. Under the cash credit system the task of cash management is passed on by the borrower to the bank. Another related aspect of the cash credit system which has received somewhat less attention is the considerable benefit derived by the borrowers akin to interest income on their temporarily surplus funds. The surplus funds credited to the cash credit account reduce interest costs at the rate charged which now stands at 17.5 per cent per annum, a level of return on surplus funds not available to other sectors of the economy. (Paragraph 11.37 and 11.38)

168. It is possible that the prevalence of the cash credit system has slowed down, if not thwarted, the development of a bill market and indeed minimised the relevance of a money market to the borrowing community. (Paragraph 11.39)

169. The development of a bill market has not been a reality despite its

well known advantages to lenders and borrowers alike and also despite the official policy actions aimed at promoting the use of bill finance. We would like to emphasise the urgency of removing the entirely avoidable procedural impediments to the use of bill finance. (Paragraph 11.40)

170. We do not believe that any system of credit regulation can be devised which can successfully promote the achievement of the stated objective of economical use of bank credit for genuine productive purposes unless it is insulated from the impact of the fluctuating financial fortunes of the large public sector units and large private sector units on the one hand and the problem of tardy payments which has become endemic in the government machinery on the other. (paragraph 11.43)

171. It is high time that due recognition is given in evolving credit policies to the fact that the public sector units along with government have achieved 'commanding heights' in the credit system no less than in other spheres of the economy. While the credit system should ensure that their genuine requirements of credit are met in adequate measure there is no justification for persisting with a system which transfers the financing charges to other sectors of the economy through the practice of non-payment of interest on delayed payments. (Paragraph 11.43)

172. Government should make it mandatory on the part of public sector and large private sector units to include an interest payment clause in all their purchase contracts with their material suppliers for payments delayed beyond a specified period, such as 120 days, at a rate which is two percentage points higher than the basic (minimum) lending rate of the bank. Similar interest payments should also be provided for in all government purchase contracts for material supplies, and purchase contracts with small scale and ancillary industries. Large units in the private sector too should naturally be required to make such a provision. (Paragraph 11.43)

173. The large public sector and private sector units need to build a strong financial structure so that they are able to transmit growth impulses to the rest of the economy on a sustained basis and not get bogged down from time to time with financial crises with their fall out on smaller borrowers.(Paragraph 11.45)

174. We recommend that cash credit limits covering supplies to government by industrial units and other suppliers may be earmarked for the purpose, and all payments by government and public sector agencies for supplies financed by these facilities should be invariably credited to the earmarked cash credit account. This arrangement would also remove one seri-

ous dislocating feature in the present system of monitoring credit limits to industry and trade.(Paragraph 11.47)

175. We recommend that credit facilities needed to tide over temporary crises of an unforeseeable nature and due to reasons beyond the control of the borrowers should be expeditiously made available by earmarking a second cash credit facility for the purpose, on lines similar to those pertaining to the cash credit facility relating to supplies to government.(Paragraph 11.48)

176. The various credit limits sanctioned by a bank may be classified under Cash Credit I (covering supplies to government), Cash Credit II (covering special circumstances or contingencies) and Normal Working Capital limits covering the balance of the credit facilities. We recommend that the Normal Working Capital limits should be predominantly in the form of loans and bill finance limits.(Paragraph 11.51)

177. The Normal Working Capital limits may be determined on the basis of Tandon/Chore norms as may be modified from time to time. We however would like to caution that Normal Working Capital limits should be carefully assessed afresh keeping in view the limits to be sanctioned in regard to Cash Credit I and Cash Credit II, and should not be mechanically derived after subtracting Cash Credit I and Cash Credit II limits from the total limits as presently computed.(Paragraph 11.51)

178. We recommend that interest charges for assistance under Cash Credit I should be at the basic (minimum) lending rate of the bank, and for Cash Credit II at the highest prevailing lending rate of the bank, the loan portion of the Normal Working Capital limits bearing an interest charge in between the two, and a special lower rate of 2 percentage points below the basic (minimum) lending rate being applicable to bill finance. (Paragraph 11.53)

179. In order that the intended benefits of instituting Cash Credit I actually accrue to the borrower it is however necessary that banks are required to amend their current practice of disregarding bills receivable or book debts which are due for more than six months in the computation of drawing power. We recommend that bills receivable and book debts should be included in the computation of drawing power for Cash Credit I so long as they are not more than 12 months old.(Paragraph 11.55)

180. Under the system proposed by us the predominance of the cash credit system of lending will be absent except in the case of Cash Credit I and Cash Credit II meant for specific purposes only and we expect the need for the former will gradually diminish over time.(Paragraph 11.57)

181. The lending system proposed by us would enable banks to monitor trends in outstandings under Cash Credit I, Cash Credit II and the Normal Working Capital limits and draw up their credit budgets on a more scientific basis.(Paragraph 11.58)

182. Credit planning by the Reserve Bank of India will be facilitated by additional information about the components of credit expansion which becomes available under the two new categories of lending proposed by us by way of Cash Credit I and Cash Credit II.(Paragraph 11.59)

183. Policies which only result in diversion of a given pool of resources by borrowers from one use to another depending on pressures from different lenders are not likely to be fruitful in the long run.(Paragraph 11.62)

184. The trends in the credit portfolio of banks so far indicate that the banks are making concerted efforts to meet the prescribed sub-targets. (Paragraph 11.64)

185. The large volume of credit being extended to the priority sector over a wide geographic area, the considerable variety of activities being financed, the large number of schemes for specific target groups, the number of agencies involved in drawing up programmes to facilitate absorption of credit by the priority sector, the enormous increase in the number of loan accounts, are notable features of priority sector lending which have made the Indian banking experience in this regard quite unique. (Paragraph 11.65)

186. The problems associated with improving the effectiveness of priority sector lending are principally in the area of organisational re-orientation and effective communication and monitoring. It should be stressed that the financial input provided by banks is only one of several inputs needed for the success of the priority sector programmes.(Paragraph 11.66)

187. A considerable amount of coordination among the developmental agencies at the district, block and even lower levels on the one hand and between these agencies and the banks on the other is a prerequisite for the efficient conduct of priority sector lending. This factor probably explains to a great extent the disparity in the results achieved under priority sector lending in different areas.(Paragraph 11.66)

188. The extent of overdues has been attracting critical attention in the course of evaluation of the performance of banks in the area of priority sector lending. The time has probably come to set maximum limits for overdues so that banks put in their best efforts to stay within these limits which would

also serve as a caution to them not to extend credit in areas which happen to show high overdues for all banks taken together. This approach would serve to elicit greater efforts from the local development agencies to improve the lending climate and the viability of priority sector projects. In this context we would like to suggest that relevant indices be developed to monitor the trends in overdues by activity and by area in respect of priority sector advances by the banking system as a whole.(Paragraph 11.68)

189. As the intensity of priority sector lending increases in an area, further growth in such lending without sacrificing lending criteria would become more difficult to achieve. It is necessary to guard against dilution of the concept of priority sector lending in such circumstances. (Paragraph 11.69)

190. Banks should make suitable evaluation of the prospects for their normal lending operations in rural areas which reflect the impact of past developmental efforts.(Paragraph 11.69)

191. The regulation of money supply in the developed countries is facilitated by the highly integrated money and capital markets of the developed economies. At the same time the task is rendered difficult by high degree of integration of economic activity among these economies. In contrast several objectives need to be pursued through monetary policy in a developing economy characterised by duality in many important respects. (Paragraphs 12.3 and 12.4)

192. We would, like to refer to the broad spectrum of tasks to be undertaken by a central bank in a developing economy like that of India as "monetary regulation".(Paragraph 12.10)

193. The broader connotation of the term 'monetary regulation' should provide greater scope for policy initiatives on the part of central banks in a wider field than generally perceived to be their domain. Such policy initiatives are very much needed in a developing economy, and should be aimed at removing the constraints on the effective use of the traditional instruments of monetary policy and at devising new instruments which facilitate the task of monetary regulation. (Paragraph 12.11)

194. Over the last several years there has been a gradual rise in the amount of money in circulation in real terms per unit of output. This phenomenon which we would like to refer to as 'monetary deepening' has important implications for monetary policy. (Paragraph 12.19)

195. Over the years the income velocity of M_3 has shown a steady decline. In 1950-51 the income velocity of M_3 was as high as 3.86. It came down to 3.12 in 1970-71 over a period of twenty years but exhibited a sharp decline over the next decade, its magnitude in 1980-81 being as low as 1.91 or less than one half of its level thirty years earlier. In 1983-84 the income velocity of M_3 was 1.86. This sharp drop in velocity since 1970-71 has probably been occasioned by the significant changes that have occurred in the structure of the monetary system, particularly the geographical spread of banking facilities, and the relatively slower growth till recently of other financial intermediaries. It would, appear that the extent of fall in velocity as a result of further expansion of banking facilities would gradually grow less and less, while the trends in the growth of other financial intermediaries may tend to more than offset any such fall. (Paragraph 12.21)

196. For purposes of monetary regulation, it is important, therefore, to analyse the factors influencing change in velocity on a continuing basis, as structural changes in the economy are policy induced and could be an important source of change in velocity. (Paragraph 12.21)

197. The major anti-inflationary factor in the long run can only be growth in output achieved through increased productivity and better technology and through an economical and effective use of credit in the economy as a whole. (Paragraph 12.21)

198. The rate of increase in the price level during the period 1951-52 to 1964-65 was no more than 2.8 per cent on an annual average basis. Taking this order of price increase as a guide, we believe an average annual increase of no more than 4 per cent per annum in the wholesale price index should provide enough room for relative prices to change over the years as may be necessitated by changes in investment priorities and technological developments. (Paragraph 12.23)

199. A sustained high rate of growth in output is a strong anti-inflationary force but a policy of maintaining relatively high rates of monetary expansion on the grounds that output growth in the long run will be raised is likely to be self-defeating if price stability is endangered in the short run. A very careful balance has, therefore, to be struck in arriving at a target for monetary expansion between the compulsions of accelerating the growth rate, and the need to achieve price stability. (Paragraph 12.25)

200. Without a detailed mid-year review it would be difficult to implement monetary regulation measures consistent with the objectives of growth, and price stability. (Paragraph 12.28)

201. In indicating sectoral targets for credit allocation, therefore, it would appear to be necessary to make a separate allocation for agro-based industries and trade as a whole which would move up or down with agricultural output. In making this comment we are aware that the presence of several linkages between different sectors of industry and trade make it difficult to assess precisely the impact of deviations from the expected rate of growth in agricultural output on any one sector or industry. Nevertheless the 'first round' effects are likely to be the more significant and these could be covered by indicating a separate allocation for agro-based industries. (Paragraph 12.29)

202. Increase in bank credit extended to industrial units should be justified by growth in sales and not merely reflect growth in inventories. Probably more attention should be given by banks to bank credit per unit of sales revenue in deciding credit requirements of their borrowers than appears to be the case at present. The use of bank credit for propping up weak and inefficient units should be reduced.(Paragraphs 12.34 and 12.35)

203. Even a moderate improvement in the performance of the large public sector organisations in important sectors like power, coal and steel would in all probability also result in a notable increase in the capacity utilisation in the industrial sector. The credit allocation measures should be flexible enough to accommodate the additional demand for credit arising out of such welcome developments. (Paragraph 12.36)

204. The availability of bank credit enables the small scale industries to continue their operations but imposes on them a burden in terms of interest cost which they find onerous. Total interest costs should be reflected in product prices, and if a part of these costs need to be absorbed by the producers at the expense of their profits, then this should be a decision to be taken by the larger producers and not forced on the small scale industries sector taking advantage of its weak bargaining power. (Paragraph 12.37)

205. Variations in the volume of credit to be allocated to different borrowers in consonance with output variations and other factors need to be quickly achieved through appropriate credit budgeting and credit appraisal procedures of banks. (Paragraph 12.39)

206. In the short run, the single most important contribution which monetary regulation measures can make towards the achievement of the goal of social justice is the maintenance of price stability.(Paragraph 12.40)

207. A matter of concern from the point of view of monetary regulation is the high overdues which banks are contending against in the implementa-

tion of priority sector lending programmes. Considering that as much as 40 per cent of total bank credit is to be allocated to priority sector advances on a sustained basis, high overdues would mean poor recycling of funds. (Paragraph 12.43)

208. We suggest that the Reserve Bank of India and the government may consider afresh all the organisational problems relating to the role of banks in financing rural development and further extending banking services in the rural areas, taking due account of the need to ensure cost effectiveness of rural lending, and the possible contribution which local agents could make to this end if their activities are integrated with the lending schemes of banks. (Paragraph 12.44)

209. The implications of RBI being a source of funds to other financial institutions need to be clearly spelt out. The creation of specific funds pursuant to the developmental role of the RBI is a source of strength to new institutions, and should remain so. However, as institutions grow and attain stature in their respective fields they can and should be able to obtain their working funds ordinarily from sources other than the Reserve Bank. (Paragraph 12.52)

210. The thrust of exchange rate policy should be to maintain the real effective exchange rate at a level, as compared to a base period, which ensures the continued competitiveness of the home country. The present policy of having an adjustable nominal exchange rate should, therefore, provide a suitable basis for maintaining the desired profile of the real effective exchange rate. (Paragraphs 12.53 and 12.54)

211. As changes in the Reserve Bank's holding of foreign exchange assets lead to changes in reserve money, these changes need to be closely monitored. (Paragraph 12.55)

212. It is important also to develop an active secondary market for Treasury Bills by providing suitable support to brokers and dealers and permitting banks also to avail of their services. (Paragraph 12.59)

213. Participation certificates provided the banks with a convenient channel for obtaining short term accommodation from the investment institutions who were able to provide such accommodation during the period which intervened between their cash inflow and the disbursement of funds for capital projects. Participation certificates of this nature deserve to be encouraged. However, it might be necessary to place restrictions on the renewability of these certificates. (Paragraph 12.62)

214. Additional institutional participants in the call money market may be allowed as they do not constitute an additional source of funds to the banking system as a whole and hence do not dilute the intended effect of monetary regulation measures. (Paragraph 12.62)

215. Development of a bill market requires an adequate supply of first class bills which alone are freely negotiable and marketable. Over the years, banks have not been encouraged to co-accept bills and as a result the bill market does not have an adequate volume of first class bills. An important step that needs to be taken by the Reserve Bank is to provide the necessary guidelines to banks in regard to co-accepting of bills. (Paragraph 12.65)

216. An active bill market will relieve pressure on banks for extending credit facilities to sellers or buyers while providing banks with a financial instrument of acceptable liquidity, safety and return. The facilities of bill rediscounting may be extended by the Reserve Bank to the commercial banks according to the stance of monetary policy at any given time. (Paragraph 12.65)

217. Evening out liquidity imbalances in the corporate sector through the development of the inter-corporate funds market would provide a means of reducing the variability in the demand for bank credit and hence providing greater manoeuvrability to monetary regulation measures. (Paragraph 12.66)

218. The still dominant influence of agriculture in the Indian economy introduces a seasonal influence on the course of economic activity. Over the recent years however the operation of a number of factors has tended to blur the distinction between the busy season and the slack season. (Paragraphs 12.67 and 12.68)

219. Although the dominant influence of agriculture in the Indian economy is still very much evident in the *level* of economic activity in a given year, it is not so much in evidence in the *seasonality* of such activity. This seems to be an important distinction to make while considering monetary regulation measures. (Paragraph 12.72)

220. It would be appropriate to announce major monetary regulation measures soon after the Government of India presents its Budget and again after the size of the kharif crop comes to be known with some degree of certainty. (Paragraph 12.73)

221. The government has commissioned a detailed study on the parallel economy which should provide useful analysis and information facilitating a

more technical discussion of the subject. In the absence of the findings of this study at the time of writing, we can only make some general observations in regard to the functioning of the monetary system in the context of the parallel economy. (Paragraph 12.74)

222. Basically, the parallel economy represents an additional source of funds to the economic agents who fail to obtain their requirements from the normal sources, or who need the funds to support activities for which they expect no assistance from the official agencies and other sources. This represents, therefore, a dilution of the effectiveness of credit control measures, and also involves a mis-direction of resources. (Paragraph 12.75)

223. A credit delivery system which succeeds in meeting the genuine requirements of borrowers for approved purposes in time and in adequate measure would reduce the spill-over of credit demand and make the operations of the parallel economy less relevant for the monetary system. (Paragraph 12.75)

224. The approach to monetary regulation which we have outlined does assume reasonable stability and predictability of the demand for money. This basic assumption is found to have adequate empirical support but the usefulness of further investigation of the demand for money function should also be stressed. (Paragraph 12.78)

225. The control of monetary expansion by monetary targeting with feedback provides the necessary flexibility to monetary policy and hence makes its closer integration with other economic policies a feasible and desirable proposition. (Paragraph 12.78)

226. We, recommend that the practice of stipulating an additional CRR requirement on incremental deposits be adopted very sparingly, for short durations, and only in special circumstances requiring drastic monetary control measures. Even if an incremental CRR is imposed, it should be converted to an average at an appropriate time. (Paragraph 13.13)

227. The rapid growth of bank deposits since 1970 has resulted in absorption of a substantial volume of government securities by banks but the ratio of government securities to total demand and time liabilities has, however, not increased over the years, as other approved securities with a higher yield have been acquired by banks to meet the rising SLR requirements. (Paragraph 13.27)

228. Our recommendations aimed at facilitating the sale of government securities to the non-institutional public as an additional channel of market

borrowing by government would lend an element of flexibility to the SLR instrument. (Paragraph 13.28).

229. In the restructured monetary system which we have outlined, reserve money expansion is not likely to be occasioned by large increases in Reserve Bank credit to government unlike in the past. In this context the refinance instrument could be effectively used in conjunction with other measures of monetary regulation, since greater variation in the quantum of refinance would become a feasible proposition. (Paragraph 13.37).

230. In keeping with the need for regulating the expansion in reserve money, the proportion of food credit supported by Reserve Bank refinance has been sought to be varied, the refinance formula being adjusted according to the overall liquidity position and the stance of monetary policy. (Paragraph 13.41).

231. Over the years food credit has been claiming not an insignificant portion of the banks' resources and presently, on an average, food credit accounts for about ten per cent of total bank credit. Food refinance facilities are an important factor affecting reserve money generation. (Paragraph 13.46)

232. The prescribed spread of 2.5 per cent between the interest rate on food credit and the rate of interest on food credit refinance cannot be considered unremunerative to banks. (Paragraph 13.46).

233. Since food credit is the first charge on lendable resources of banks, and since the threshold for food credit refinance is being raised continually, the rate of interest prescribed for food credit has to be kept under review so that it bears a reasonable relation to the average cost of funds for banks. (Paragraph 13.46).

234. The role of open market operations as an instrument of credit control will assume importance in the restructured monetary system recommended by us. With the interest rate offered on government securities becoming truly competitive, a broad enough securities market may emerge for the Reserve Bank to use open market operations as an instrument of credit control. (Paragraph 13.57)

235. In the restructured monetary system which we have outlined there would be scope for improving the effectiveness of Bank Rate as an instrument of monetary regulation particularly if necessary steps are taken to develop an active money market as recommended by us. Further, if banks'

recourse to Reserve Bank accommodation rises as a result of our recomendations relating to regulation of reserve money expansion the Reserve Bank will be in a better position to influence banks' operations through Bank Rate policy. Again, the interest rates on Reserve Bank credit to the commercial sector could be specified only in relation to the Bank Rate. (Paragraph 13.63)

236. Selective credit control is operated as an adjunct to general credit control. It is intended to ensure an adequate credit flow to the desired sectors while preventing excessive credit drawal for less essential economic activities. (Paragraph 13.64)

237. To what extent selective credit policy measures have attained their objectives is a question that does not lend itself to any easy evaluation. (Paragraph 13.74)

238. The business community can and does take recourse to other sources of finance outside the organised money market and thus thwart the objectives of selective credit control. It would perhaps be inappropriate to judge the efficacy of selective credit control measures in terms of their impact on prices. (Paragraph 13.75)

239. We note with interest the measures for the simplification of selective credit controls announced by the Reserve Bank in April 1985. (Paragraph 13.76)

240. Moral suasion is a means of strengthening mutual confidence and understanding between the monetary authority and the banks as well as financial institutions and therefore is an essential instrument of monetary regulation. (Paragraph 13.80)

241. A caution which needs to be sounded on the basis of recent experience is that the conduct of monetary policy should not be dependent excessively on any single or just a few instruments of monetary regulation. (Paragraph 13.81)

242. Disaggregated data relating to the banking system is available with a considerable time lag and hence do not permit analytical studies of operational significance. (Paragraph 14.6)

243. There is need for further intensive investigations of the demand for money function and the factors influencing household savings in the form of financial assets. (Paragraph 14.19)

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9.1 Money, Output and Prices
9.2 Money, Output and Prices : Annual Variations
11.1 Report of the Study Group to Frame Guidelines for Follow-up of Bank Credit (Tandon Commitee) 1975 – Summary of recommendations
11.2 Report of the Working Group to Review the System of Cash Credit (Chore Committee) 1979 – Summary of recommendations
11.3 Report of the Working Group and the Role of Banks in Implementation of New 20-Point Programme (Ghosh Committee) 1982 – Summary of recommendations
11.4 Report of the Committee to Review the Working of the Credit Authorisation Scheme (Marathe Committee) 1983 – Summary of recommendations

Annexure 1.1

Commissioned Studies

	Title of the technical study/paper	Name of the expert
1.	Monetary Policy, Growth and Stability – A Case Study of India.	Dr. V. N. Pandit
2.	Alternative Modes of Financing Public Expenditure and the Trade-Off between Inflation and Growth.	Dr. B. B. Bhattacharya and Dr. V. N. Pandit
3.	Quarterly Prediction of the Reserve Money Multiplier and the Money Stock in India.	Dr. V. S. Chitre
4.	Monetary Target Setting	Dr. G. S. Gupta
5.	Demand for Currency and Deposits.	Dr. A. Lahiri
6.	Causality between Money and Price Level in India.	Dr. B. B. Bhattacharya and Dr. P. D. Sharma
7.	System of Administered Interest Rates in India.	Dr. L. M. Bhole
8.	Role of Interest Rates as an Incentive for Household Saving in India 1960-61 to 1981-82.	Dr. B. B. Bhattacharya
9.	Relationship between Rate of Interest and Investment.	Shri N. J. Jhaveri
10.	Non-Banking Financial Intermediaries.	Institute for Financial Management and Research, Madras
11.	Financing of Trade in Groundnut, Groundnut Processing and Distribution of Finished Products.	Dr. U. K. Srivastava
12.	Financing of Kapas-Cloth System.	Dr. S. P. Seetharaman
13.	Profitability of Banks and Related Aspects.	Dr. Kala S. Pant and Dr. V. H. Patil
14.	Guidelines for Bank Lending and Follow Up.	Shri S. G. Shah
15.	Economies of scale in Banking at the Branch Level.	Dr. S. A. H. Zaidi

Annexure 1.2

List of Institutions etc to whom Questionnaires were sent

		Number
1.	Commercial Banks (State Bank of India and its subsidiaries, Nationalised Banks, private sector banks, Regional Rural Banks, Foreign Banks)	83
2.	Co-operative Banks (State Co-operative Banks, District Central Co-operative Banks, Urban Co-operative Banks, etc.)	1818
3.	Trade Unions/Associations of Reserve Bank of India and Commercial Banks.	12
4.	Chambers of Commerce, Industry Associations and Export Promotion Councils.	156
5.	All India Financial Institutions.	21
6.	Stock Exchanges and Stock Brokers	67
7.	Public Sector Undertakings and State Sponsored Institutions.	98
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9.	Universities and other Institutions.	88
10.	Economists	127

Annexure 1.3

List of Institutions with whom the Committee had discussions

1. Reserve Bank of India
2. Bank of India
3. Allahabad Bank
4. United Bank of India
5. Industrial Development Bank of India
6. Unit Trust of India
7. Federation of Indian Chambers of Commerce and Industry
8. Indian Chamber of Commerce
9. Bombay Chamber of Commerce
10. Bharat Merchants' Chamber
11. Bombay Stock Exchange

Annexure 1.4

Secretariat Staff

Officers

Dr. J. C. Rao (Secretary)
Shri Rajendra Kumar *
Shri J. M. Lopez *
Shri Y. S. R. Sarma
Shri A. V. Bhuleshkar
Dr. V. B. Angadi
Dr. T. K. Chakrabarty
Shri A. K. Ray *
Shri K. A. Menon
Shri N. R. Patwardhan
Shri P. Chandramowleeswaran
Smt. Sarojini Venkatachalam
Shri A. M. Thenge *
Shri P. V. Narayanan

Supporting Staff

Shri S. L. Narayana (Economic Assistant)
Smt. V. M. Gadgil (Economic Assistant)
Smt. N. S. Deshpande (Economic Assistant)
Smt. S. P. Desai (Economic Assistant)
Smt. R. Periera (Economic Assistant)
Shri S. B. Sapre (Clerk)
Shri R. B. Salian (Clerk)

Administrative Staff

Smt. L. N. Iyer
Smt. G. R. Keni
Smt. A. Thomas
Smt. L. F. Fernandes
Shri L. S. Nepali
Shri B. T. More
Shri A. B. Rane
Shri K. M. Rode
Shri S. G. Dalvi
Shri P. L. Fernandes

* These officers were associated with the Secretariat for a brief period.

Annexure 3.1

Yields on Government of India Securities and Other Interest Rates

(per cent)

	Year ending March	1970-71	1977-78	1979-80	1981-82	1983-84
1.	Bank Rate	5.00–6.00	9.00	9.00	10.00	10.00
2.	Treasury Bill Rate	3.00–3.50	4.60	4.60	4.60	4.60
3.	Call Money Rate (Bombay)	6.38	9.28	8.47	8.96	8.63
4.	Bank Deposit Rates (above 5 years)	7.25	9.00	10.00	10.00	11.00
5.	Company Deposit Rates (3 years)					
	i) Private Sector	–	11.00–16.50	10.50–15.00	13.00–15.50	14.00–15.00
	ii) Public Sector	–	–	–	13.50	13.50–14.50
6.	UTI Dividend Rate	8.00	9.00	10.00	12.50	14.00
7.	Debentures (non-convertible)	8.00	10.50	10.50	13.50	15.00
8.	Average yield (Gross) ordinary shares	5.53	6.47	5.83	5.51	5.18
9.	Redemption yield on Government of India Securities					
	i) Short-Term (under 5 years)	3.85–4.28	5.06–5.59	4.70–5.74	5.32–6.43	4.50–7.08
	ii) Medium-Term (Between 5 & 15 Yrs.)	4.32–4.84	5.42–5.98	5.70–6.30	5.81–7.02	6.67–9.04
	iii) Long-Term (over 15 Years)	4.77–5.53	6.03–6.46	6.20–6.98	6.45–8.00	6.47–10.00

Source : Report on Currency and Finance (Reserve Bank of India).

Annexure 4.1

Gross Domestic Saving – Sectoral Composition

(at current prices)

(Rupees Crores)

Year ending March	Gross Domestic Saving				Gross Domestic Saving as per cent of Gross Domestic Product at market prices			
	Public Sector	Private Corporate Sector	House-hold Sector	Total	Public Sector	Private Corporate Sector	House-hold Sector	Gross Domestic Saving
1950–51	168	89	718	975	1.8	0.9	7.5	10.2
1951–52	252	132	621	1005	2.5	1.3	6.2	10.0
1952–53	145	60	601	806	1.5	0.6	6.2	8.3
1953–54	127	86	709	922	1.2	0.8	6.8	8.8
1954–55	151	114	789	1054	1.6	1.2	8.1	10.9
1955–56	172	130	1128	1430	1.7	1.2	11.0	13.9
1956–57	231	151	1217	1599	1.9	1.3	10.3	13.5
1957–58	245	117	1008	1370	2.0	1.0	8.4	11.4
1958–59	227	136	1046	1409	1.7	1.0	7.8	10.5
1959–60	236	180	1349	1765	1.7	1.3	9.6	12.6
1960–61	425	276	1362	2063	2.8	1.8	9.1	13.7
1961–62	494	315	1284	2093	3.1	2.0	8.0	13.1
1962–63	566	338	1572	2476	3.3	2.0	9.2	14.5
1963–64	709	387	1730	2826	3.6	2.0	8.8	14.4
1964–65	817	381	1937	3135	3.5	1.7	8.4	13.6
1965–66	809	396	2586	3791	3.4	1.6	10.7	15.7
1966–67	668	414	3432	4514	2.4	1.5	12.4	16.3
1967–68	667	399	3431	4497	2.1	1.2	10.6	13.9
1968–69	858	427	3412	4697	2.6	1.3	10.2	14.1
1969–70	1033	536	4475	6044	2.8	1.5	12.1	16.4

Annexure 4.1

Gross Domestic Saving – Sectoral Composition (contd.)

(at current prices)

(Rupees Crores)

Year ending March	Gross Domestic Saving				Gross Domestic Saving as per cent of Gross Domestic Product at market prices			
	Public Sector	Private Corporate Sector	House hold Sector	Total	Public Sector	Private Corporate Sector	House hold Sector	Gross Domestic Saving
1970–71	1253	657	4873	6783	3.1	1.6	12.1	16.8
1971–72	1278	754	5466	7498	3.0	1.7	12.6	17.3
1972–73	1333	787	5649	7769	2.8	1.6	11.8	16.2
1973–74	1807	1063	8522	11392	3.1	1.8	14.4	19.3
1974–75	2676	1440	8537	12653	3.8	2.1	12.3	18.2
1975–76	3339	1056	10452	14847	4.5	1.4	14.1	20.0
1976–77	4185	1128	12592	17905	5.2	1.4	15.8	22.4
1977–78	4168	1327	14267	19762	4.7	1.5	15.9	22.1
1978–79	4781	1607	17694	24081	4.9	1.7	18.1	24.7
1979–80	4967	2249	17623	24839	4.6	2.1	16.5	23.2
1980–81	4640	2543	22030	29213	3.6	2.0	17.3	22.9
1981–82 @	7277	2789	22599	32665	4.9	1.9	15.3	22.1
1982–83 @	8231	3157	25934	37322	5.0	1.9	15.9	22.8
1983–84 *	7970	3385	32817	44172	4.1	1.7	16.8	22.6

@ Provisional Estimates.

* Quick Estimates.

Sources : Report of the Working Group on Savings (Government of India) February 1982.

National Accounts Statistics (Central Statistical Organisation, Government of India).

Quick Estimates of National Product, Consumption, Saving and Capital Formation (Central Statistical Organisation, Government of India).

Annexure 4.2

Gross Domestic Capital Formation – Sectoral Composition

(at current prices)

(Rupees Crores)

Year ending March	Gross Domestic Capital Formation	Public Sector	Private Sector			Sectoral Share (per cent)			
			Total	Corporate Business	House-holds	Public Sector	Private Sector		
							Total	Corporate Business	House-holds
1950–51	1130	260	870	214	656	23.0	77.0	18.9	58.1
1951–52	1162	304	858	251	607	26.2	73.8	21.6	52.2
1952–53	859	257	602	73	529	29.9	70.1	8.5	61.6
1953–54	864	293	572	5	567	33.9	66.1	0.5	65.6
1954–55	1088	437	652	144	508	40.1	59.9	13.2	46.7
1955–56	1416	498	918	219	699	35.2	64.8	15.5	49.3
1956–57	1891	666	1225	341	884	35.2	64.8	18.0	46.8
1957–58	1940	833	1107	390	717	42.9	57.1	20.1	37.0
1958–59	1737	815	922	238	684	46.9	53.1	13.7	39.4
1959–60	2114	901	1213	297	916	42.6	57.4	14.1	43.3
1960–61	2582	1141	1441	535	906	44.2	55.8	20.7	35.1
1961–62	2680	1147	1533	738	795	42.8	57.2	27.5	29.7
1962–63	3051	1445	1606	533	1073	47.4	52.6	17.5	35.1
1963–64	3529	1681	1848	861	987	47.6	52.4	24.4	28.0
1964–65	4069	1948	2121	898	1223	47.9	52.1	22.1	30.0
1965–66	4426	2215	2211	696	1515	50.1	49.9	15.7	34.2
1966–67	5316	2135	3181	615	2566	40.2	59.8	11.5	48.3
1967–68	5707	2332	3376	809	2567	40.9	59.1	14.1	45.0
1968–69	5540	2168	3372	756	2616	39.1	60.9	13.6	47.3
1969–70	6476	2259	4217	661	3556	34.9	65.1	10.2	54.9

Annexure 4.2

Gross Domestic Capital Formation – Sectoral Composition (contd.)

(at current prices)

(Rupees Crores)

Year ending March	Gross Domestic Capital Formation	Public Sector	Private Sector			Sectoral Share (per cent)			
			Total	Corporate Business	House-holds	Public Sector	Private Sector		
							Total	Corporate Business	House-holds
1970–71	7344	2812	4532	1030	3502	38.3	61.7	14.0	47.7
1971–72	8411	3213	5198	1286	3912	38.2	61.8	15.3	46.5
1972–73	8526	3674	4852	1332	3520	43.1	56.9	15.6	41.3
1973–74	11352	4812	6540	1630	4910	42.4	57.6	14.4	43.2
1974–75	14510	5640	8870	2707	6163	38.9	61.1	18.6	42.5
1975–76	16419	7746	8673	2139	6534	47.2	52.8	13.0	39.8
1976–77	17669	8569	9100	1291	7809	48.5	51.8	7.3	44.2
1977–78	18548	7671	10877	2338	8539	41.4	58.6	12.6	46.0
1978–79	22933	9741	13192	2245	10947	42.5	57.5	9.8	47.7
1979–80	26228	11929	14299	3295	11004	45.5	54.5	12.6	41.9
1980–81	31443	14047	17396	3938	13458	44.7	55.3	12.5	42.8
1981–82@	36099	17439	18660	5159	13501	48.3	51.7	14.3	37.4
1982–83@	40422	19893	20529	6045	14484	49.2	50.8	15.0	35.8
1983–84*	47377	21900	25477	6916	18561	46.2	53.8	14.6	39.2

@ Provisional Estimates
* Quick Estimates

Sources : Report of the Working Group on Savings (Government of India) February 1982.
National Accounts Statistics (Central Statistical Organisation Government of India).
Quick Estimates of National Product, Consumption, Saving and Capital Formation (Central Statistical Organisation Government of India).

Annexure 4.3

Saving (Gross) of the Household Sector in the form of Financial Assets (at current prices)

(Rupees Crores)

	Instrument	1951-52	1952-53	1953-54	1954-55	1955-56	1956-57	1957-58	1958-59
a)	Currency	-115	-22	25	85	190	52	55	121
		(-425.9)	(-39.3)	(20.0)	(22.9)	(37.0)	(11.3)	(13.4)	(25.2)
b)	Bank Deposits (1)	-19	19	12	64	85	100	114	111
		(-70.4)	(33.9)	(9.6)	(17.2)	(16.6)	(21.8)	(27.8)	(23.1)
c)	Life Insurance Fund (2)	16	22	27	31	35	25	22	35
		(59.2)	(39.3)	(21.6)	(8.3)	(6.8)	(5.5)	(5.4)	(7.3)
d)	Provident Funds (3)	18	23	42	44	50	60	72	68
		(66.3)	(41.1)	(33.6)	(11.8)	(9.8)	(13.1)	(17.6)	(14.1)
e)	Units of Unit Trust of India	-	-	-	-	-	-	-	-
f)	Claims on Government	104	1	-5	109	102	140	53	93
		(385.2)	(1.8)	(-4.0)	(29.3)	(19.9)	(30.6)	(12.9)	(19.3)
g)	Compulsory Deposits	-	-	-	-	-	-	-	-
h)	Deposits with Companies (4)	-	-	-	-	-	6	12	-5
							(1.3)	(2.9)	(-1.0)
i)	Investments in Shares/Debentures of Corporate/Co-operative Sector	23	13	24	38	51	54	50	26
		(85.2)	(23.2)	(19.2)	(10.2)	(9.9)	(11.8)	(12.2)	(5.4)
j)	Trade Credit	-	-	-	-	-	21	31	32
							(4.6)	(7.6)	(6.6)
	Saving (Gross) of Household Sector in Financial Assets (a to j)	27	56	125	372	513	458	410	481
		(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Saving (Gross) of the Household Sector in the form of Financial Assets (contd.)

(Rupees Crores)

	Instrument	1959-60	1960-61	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67
a)	Currency	132 (23.3)	147 (29.3)	99 (14.9)	174 (25.4)	217 (21.4)	135 (15.7)	287 (25.9)	126 (11.1)
b)	Bank Deposits (1)	115 (27.4)	71 (14.2)	207 (31.2)	177 (25.8)	293 (28.9)	336 (39.2)	364 (32.9)	438 (38.6)
c)	Life Insurance Fund (2)	45 (8.0)	62 (12.4)	73 (11.0)	91 (13.3)	94 (9.3)	97 (11.3)	90 (8.1)	142 (12.5)
d)	Provident Funds (3)	79 (14.0)	109 (21.7)	114 (17.2)	129 (18.8)	155 (15.3)	182 (21.2)	198 (17.9)	210 (18.5)
e)	Units of Unit Trust of India	–	–	–	–	–	16 (1.9)	2 (0.2)	7 (0.6)
f)	Claims on Government	58 (10.2)	90 (18.0)	39 (5.9)	70 (10.2)	100 (9.9)	91 (10.6)	105 (9.5)	77 (6.8)
g)	Compulsory Deposits	–	–	–	–	–	–	–	–
h)	Deposits with Companies (4)	14 (2.5)	67 (13.4)	48 (7.2)	71 (10.3)	53 (5.2)	44 (5.1)	23 . (2.1)	78 (6.9)
i)	Investments in Shares/Debentures of Corporate/Co-operative Sector	55 (9.7)	125 (24.9)	70 (10.5)	25 (3.6)	113 (11.2)	10 (1.2)	22 (2.0)	15 (1.3)
j)	Trade Credit	28 (4.9)	–170 (–33.9)	14 (2.1)	–51 (–7.4)	–13 (–1.3)	–53 (–6.2)	16 (1.4)	41 (3.6)
	Saving (Gross) of Household Sector in Financial Assets (a to j)	566 (100.0)	501 (100.0)	664 (100.0)	686 (100.0)	1,013 (100.0)	858 (100.0)	1,107 (100.0)	1,134 (100.0)

Annexure 4.3

Saving (Gross) of the Household Sector in the form of Financial Assets (contd.)

(Rupees Crores)

	Instrument	1967-68	1968-69	1969-70	1970-71	1971-72	1972-73	1973-74	1974-75
a)	Currency	161	271	336	354	404	637	769	18
		(14.0)	(20.7)	(21.9)	(17.0)	(17.2)	(21.2)	(21.2)	(0.5)
b)	Bank Deposits (1)	408	413	548	795	1,020	1,211	1,507	1.512
		(35.6)	(31.6)	(35.7)	(38.2)	(43.5)	(40.3)	(41.5)	(44.4)
c)	Life Insurance Fund (2)	150	184	189	220	251	307	356	344
		(13.1)	(14.0)	(12.3)	(10.6)	(10.7)	(10.2)	(9.8)	(10.1)
d)	Provident Funds (3)	269	273	358	422	474	523	603	787
		(23.5)	(20.9)	(23.3)	(20.2)	(20.2)	(17.4)	(16.6)	(23.1)
e)	Units of Unit Trust of India	14	15	21	14	12	19	24	-3
		(1.2)	(1.1)	(1.3)	(0.7)	(0.5)	(0.6)	(0.6)	(-0.1)
f)	Claims on Government	105	57	-28	113	3	84	90	214
		(9.2)	(4.4)	(-1.8)	(5.4)	(0.1)	(2.8)	(2.5)	(6.3)
g)	Compulsory Deposits	-	-	-	-	-	-	-	-
h)	Deposits with Companies (4)	54	103	58	67	104	108	45	92
		(4.7)	(7.9)	(3.8)	(3.2)	(4.4)	(3.6)	(1.2)	(2.7)
i)	Investments in Shares/Debentures of Corporate/Co-operative Sector	28	25	26	67	20	27	-16	62
		(2.4)	(1.9)	(1.7)	(3.2)	(0.9)	(0.9)	(-0.4)	(1.8)
j)	Trade Credit	-43	-33	28	32	59	88	253	376
		(-3.7)	(-2.5)	(1.8)	(1.5)	(2.5)	(2.9)	(7.0)	(11.1)
	Saving (Gross) of Household Sector in Financial Assets (a to j)	1,146	1,308	1,536	2,084	2,347	3,004	3,631	3,402
		(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Annexure 4.3

Saving (Gross) of the Household Sector in the form of Financial Assets (contd.)

(Rupees Crores)

	Instrument	1975-76	1976-77	1977-78	1978-79	1979-80*	1980-81*	1981-82*	1982-83$	1983-84†
a)	Currency	342	1,140	703	1,430	1,332	1,628	985	2,133	2,794
		(6.9)	(16.5)	(9.8)	(15.1)	(13.0)	(14.5)	(7.1)	(13.5)	(14.7)
b)	Bank Deposits (1)	1,129	3,307	3,521	4,626	4,659	5,059	5,025	6,015	7,597
		(42.6)	(47.9)	(49.2)	(48.7)	(45.4)	(45.1)	(36.0)	(38.2)	(40.0)
c)	Life Insurance Fund (2)	422	524	592	683	773	908	997	1,235	1,386
		(8.5)	(7.6)	(8.3)	(7.2)	(7.5)	(8.1)	(7.1)	(7.8)	(7.3)
d)	Provident Funds (3)	1,080	1,171	1,316	1,605	1,748	2,070	2,302	2,941	3,217
		(21.6)	(17.0)	(18.4)	(16.9)	(17.0)	(18.4)	(16.5)	(18.7)	(16.9)
e)	Units of Unit Trust of India	16	20	34	79	41	33	39	121	195
		(0.3)	(0.3)	(0.5)	(0.8)	(0.4)	(0.3)	(0.3)	(0.8	(1.0)
f)	Claims on Government	91	19	311	543	737	743	1,730	1,241	1,594
		(1.8)	(0.3)	(4.3)	(5.7)	(7.2)	(6.6)	(12.4)	(7.9)	(8.4)
g)	Compulsory Deposits	741	613	14	−316	−207	−94	20	34	55
		(14.8)	(8.9)	(0.2)	(−3.3)	(−2.0)	(−0.8)	(0.1)	(0.2)	(0.3)
h)	Deposits with Companies (4)	130	114	227	232	477	321	1,701	1,214	1,252
		(2.6)	(1.7)	(3.2)	(2.4)	(4.7)	(2.9)	(12.2)	(7.7)	(6.6)

Saving (Gross) of the Household Sector in the form of Financial Assets (concld.)

(Rupees Crores)

	Instrument	1975-76	1976-77	1977-78	1978-79	1979-80*	1980-81*	1981-82*	1982-83$	1983-84†
i)	Investments in Shares/Debentures of Corporate/Co-operative Sector	43 (0.9)	-5 (-0.1)	200 (2.8)	203 (2.1)	253 (2.5)	185 (1.6)	440 (3.2)	376 (2.4)	507 (2.7)
j)	Trade Credit		2 (Negl.)	241 (3.3)	415 (4.4)	447 (4.3)	369 (3.3)	709 (5.1)	438 (2.8)	403 (2.1)
	Saving (Gross) of Household Sector in Financial Assets (a to j)	4,994 (100.0)	6,905 (100.0)	7,160 (100.0)	9,500 (100.0)	10,260 (100.0)	11,222 (100.0)	13,948 (100.0)	15,748 (100.0)	19,000 (100.0)

Notes : Due to change in methology, estimates from 1979-80 onwards are not strictly comparable with those for earlier years.

Percentages do not add to total due to rounding.

1) Includes deposits with co-operative non-credit societies.
2) Including State Governments and Postal Insurance Fund.
3) Includes contributory pension fund from 1979-80 onwards.
4) Includes deposits with non-banking companies.

* Provisional.
$ Preliminary.
+ Tentative.

Sources : Chart Book on Financial And Economic Indicators (Reserve Bank of India). 1977
Report on Currency and Finance (Reserve Bank of India).

Annexure 4.4

Indicators of Financial Development

	Finance Ratio (FR)	Financial Inter-relations Ratio (FIR)	New Issue Ratio (NIR)	Intermediation Ratio (IR)
1951-52	0.01	0.08	0.17	–
1952-53	0.01	0.33	0.43	–
1953-54	0.03	0.63	0.47	0.33
1954-55	0.06	0.91	0.56	0.61
1955-56	0.11	1.08	0.69	0.57
1956-57	0.08	0.60	0.38	0.60
1957-58	0.09	0.87	0.56	0.54
1958-59	0.10	1.14	0.74	0.55
1959-60	0.12	1.26	0.84	0.50
1960-61	0.08	0.70	0.56	0.24
1961-62	0.11	1.07	0.72	0.49
1962-63	0.11	0.99	0.69	0.44
1963-64	0.13	1.10	0.76	0.45
1964-65	0.11	0.93	0.62	0.50
1965-66	0.14	1.10	0.76	0.45
1966-67	0.13	0.86	0.59	0.45
1967-68	0.12	0.92	0.65	0.41
1968-69	0.11	0.91	0.57	0.60
1969-70	0.11	0.88	0.57	0.54
1970-71	0.15	1.15	0.69	0.66
1971-72	0.14	1.05	0.61	0.71
1972-73	0.16	1.32	0.72	0.82
1973-74	0.14	1.02	0.50	1.05
1974-75	0.16	0.93	0.58	0.61
1975-76	0.21	1.36	0.78	0.75
1976-77	0.22	1.32	0.74	0.78
1977-78	0.25	1.70	0.92	0.86
1978-79	0.19	0.99	0.61	0.61
1979-80	0.28	1.60	0.91	0.75
1980-81	0.27	1.47	0.90	0.63
1981-82*	0.23	1.34	0.76	0.77

* Provisional.

Notes : Ratios are based on flows.

Sources : Chart Book on Financial And Economic Indicators, (Reserve Bank of India) 1977.
Flow of Funds in the Indian Economy (Reserve Bank of India Bulletin.)
Report on Currency and Finance (Reserve Bank of India).

REPORT OF THE COMMITTEE ON MECHANISATION IN BANKING INDUSTRY - R.B.I. (1984)
(Chairman : Dr. C. Rangarajan)

LIST OF RECOMMENDATIONS

1. The Committee recommends that the process of mechanisation should encompass activities at the branch, regional and head office levels, with emphasis varying from one level to another. (Para 3.6)

2. At the branch level, system will have to be so designed as to ensure generation of data as a by product of the operations at the branch level. (Para 3.7)

3. Branch level mechanisation should be implemented under either model I or model II of mechanisation. Under model I, stand alone electronic ledger posting machines with attached memory modules will be installed. The machine will have a typewriter keyboard, a video screen, two floppy disc drives and a printer. The machine performs: (a) maintenance of primary ledgers and posting transaction entries in them, (b) working out products and interests at periodical intervals, (c) prepares statement of accounts for customers and (d) listing of standing instructions to be executed in the accounts. For different counters dedicated functional machines should be developed. For example, one of the machines will be designed to generate day book and general ledger. On an average, each branch may need three or four such machines. In alternate model II of mechanisation, a single microprocessor based system of large capacity will be installed. This machine will store all the primary ledger and general ledger accounts and besides performing all the functions of the electronic ledger posting machine described above, it will print out various statistical returns and statements for branch level information system. (Paras 4.18 to 4.28)

4. While the choice of either model I or model II of mechanisation to be made at any branch would depend on the circumstances obtaining it, model II of mechanisation will be best suited for big branches. (Para 4.29)

5. Introduction of machines at the branch level would call for changes in work systems. Existing checks and counterchecks should not be discontinued and additional safeguards should be built into the operating procedures. It will be useful if the branches which introduce these machines switch over to a Teller System. The working out of comprehensive checks and safeguards would have to be given top priority and should be a condition preceding the introduction of machines. (Paras 4.31 and 4.32)

6. For recording cash payments/receipts, modified versions of cash registers may be introduced. (Para 4.33)

7. Banks may select a few branches and implement either of the models on a pilot basis. During this period, parallel runs as per the existing manual procedures and new machine procedures may be undertaken. (Para 4.35)

8. Credit information system may be built up in the form of a master office file containing one time classificatory information on each borrowal account and a transaction file to be built up from account level balances. For this purpose, branches should prepare control cards for each account and carbon copies of control cards and monthly jotting sheets of account level balances should be sent to zonal/regional offices for further processing on their microprocessor systems. (Paras 5.6 to 5.10)

9. Classificatory codes and nomenclatures of different types of transactions may be standard-

ised and made uniform for all the returns. Frequent changes in the form and classificatory items should be avoided. (Para 5.8)

10. To facilitate speedy clearance of cheques, service branches should be established by banks in centres where they have more than ten branches. (Para 6.11)

11. Information system on foreign exchange transactions in large branches should be supported under model II of mechanisation. In such large branches, the microprocessor based system which will be installed to support domestic business should also be used to process foreign exchange transactions. (Para 7.16)

12. The dealing room transactions should be supported by a separate computer system working in real time environment, with a capability of being connected to the system in other dealing rooms. (Para 7.17)

13. It would be appropriate to allow major banks in India to import computer systems with software packages for their foreign exchange transactions, if needed. (Para 7.20)

14. The computer systems in head offices of banks should be mainframe systems with on-line inquiry terminals. Smaller banks could go in four microprocessor systems with sufficiently large capacity. Banks should computerise processing of statutory and other statistical returns, reconciliation of inter-branch transactions, cash and investment management, pay rolls, provident fund accounting and personnel inventory data. They should maintain time series data on financial, monetary and economic variables. (Paras 8.5 to 8.13)

15. It is necessary to equip zonal/regional offices with microprocessor based systems and off-line data entry machines. They should transcribe data received from branches on computer media and edit and reformat them wherever necessary and transmit the same to their head offices. Zonal/regional offices should also process these data for their own control purposes. (Para 8.14)

16. Input-output formats should be standardised. A glossary of terms/items in various books of accounts should be prepared and standardised with uniform code designs. Input forms may be designed as far as possible. With pre-printed codes, to avoid extra effort of coding the forms. Reserve Bank should examine all the coding systems in different returns with a view to standardising them. (Paras 8.17 and 8.18)

17. Even under mechanised systems, the existing procedures of data transmission through different tiers of banks should continue. (Para 8.22)

18. The programme of mechanisation should be implemented in five years, in two stages. Stage I will cover the three year period 1985 to 1987 and stage II will cover the remaining two years, 1988 and 1989. A detailed review of the programme should be undertaken at the end of stage I (Para 9.4)

19. In the first stage, installation of mainframe systems in head offices, microprocessor systems in zonal/regional offices covering about 200 branches should be completed. The mainframe system should have one megabyte real memory, 200-400 megabytes of disc storage supported by two floppy disc drives, three tape drives, two line printers and a few on-line inquiry terminals. The system may also have a card reader, if necessary. The microprocessor system should have one megabyte of real memory, 80 megabytes of disc storage with one or two floppy disc drives, one or two tape units, one line printer and eight off-line data entry terminals. There could be some variations in these configurations depending on the size of the bank. The systems should have upgradation potentiality. (Paras 9.5 and 9.6)

20. Under branch level mechanisation, branches having an average workload of about 1,000 vouchers per day should be equipped with electronic ledger posting machines with attached

memory modules or microprocessor based system. This need not preclude branches having a workload of less than 1,000 vouchers per day to implement either of these models, if it is found desirable from the point of view of customer services. It is estimated that stage I will cover about 2,500 branches. In stage II, additional 6,000 branches will be covered. (Paras 9.7 and 9.8)

21. While it is desirable that the programme of mechanisation in the three tiers is implemented as a package, the installation of mainframe systems and microprocessors in higher tiers need not be held up till branch level mechanisation is completed. (Para 9.7)

22. In stage I the industry would need about 10,000 electronic ledger posting machines with memory modules, 200 microprocessor based systems and 25 mainframe systems. The investment in hardware would be about Rs. 135 crores. (Para 9.10)

23. Banking Industry will need about 40,000-45,000 operators and 1,000 systems analysts and programmers. These personnel requirements will largely be met from the existing staff. Training of operators and programmers may be arranged by banks. Training of systems analysts should be designed and conducted by the National Institute of Bank Management. (Paras 9.12 to 9.14)

24. Banks may examine whether a separate crdre of EDP personnel should be created within banks. (Para 9.15)

25. Banks may create immediately EDP Cells in their organisations and initiate advance actions. (Para 9.20)

26. The Indian Banks' Association should take the overall responsibility of planning, coordinating and implementing the programme of mechanisation. It should be supported in this endeavour by Government agencies and other apex level institutions. (Para 9.22)

27. A Standing Committee under the chairmanship of a Deputy Governor of the Reserve Bank of India should be set up by the Reserve Bank to monitor the implementation of the programme of mechanisation. The Committee should have members drawn from Department of Electronics, Ministry of Finance and the Indian Banks' Association, among others. (Para 9.23)

28. The requirements of branch level mechanisation should be met indigenously. In the context of large scale requirements of equipments, it is necessary to create sufficient manufacturing capacity and also allow import of know-how and electronic parts as are needed. The Department of Electronics should plan and coordinate the activities of manufacturers of these equipments. (Para 9.24)

Annexure 5.2

Profile of non-banking financial companies*

The term non-banking financial companies covers investment companies, finance corporations, chit funds, nidhis and mutual benefit funds, hire-purchase finance companies, loan companies and leasing companies. The functioning of these companies is briefly reviewed in the following paragraphs.

Investment Companies : The main function of investment companies which are also known as investment trust companies and investment trusts, is to mobilise savings and invest them in industrial securities with the object of providing remunerative yield to savers and reducing the risk of capital depreciation by diversifying investments. A survey of these companies revealed that the private limited companies did not function as investment companies. Most of them do not transact any business, and a few of them are engaged in business other than investment in securities. The funds of the companies are mostly contributed by the directors and members. Rarely do these companies borrow from the public although they are allowed to borrow upto 25 per cent of their paid-up capital and reserves. The purpose of floating private limited companies seemed to be to evade payment of taxes. On the other hand, public limited investment companies do undertake some investment business. Many of them invest in the shares floated by companies in which the directors have a controlling interest. The connections between investment companies and the commercial banks is that some of them borrow funds from banks on the strength of their investments and re-lend these funds to industrial companies in their respective groups or to third parties. Such borrowings and lendings are, however, very small in size. Investment companies operate within the Companies Act and are also controlled by the provision of Non-banking companies (Reserve Bank) Directions 1977.

Finance Corporations : These are set up for making profit from the business of lending resources mainly raised by way of deposits or borrowings. It may be run as a proprietary concern, a partnership firm or a private limited or a public limited company. A proprietary concern has to obtain a licence under the Money Lender's Act before commencement of business and a partnership firm requires to be registered under the Indian Partnership Act. All partnerships keep their capital subcribed below one lakh of rupees in order to remain outside the purview of the regulations of the Reserve Bank of India. They accept recurring and short notice deposits but the bulk of the deposits are term deposits. Term deposits have a

* This note is based on a study undertaken by the Institute for Financial Management and Research (Madras) for the Committee.

maturity ranging from 1 to 5 years; fifty per cent of deposits accepted are for a period of one year. They offer attractive interest rates on deposits ranging from 12 per cent on a one-year deposit to 20 per cent on a five-year deposit. The rates and other terms and conditions, differ from State to State and among centres within a State. Higher levels of interest rates and the practice of monthly payment of interest which raises the effective rate of return induce the savers to deposit money with these corporations even at great risk. Finance corporations have come into existence because credit is not available from the lending agencies in the organised sector for certain business activities or against certain types of securities. These corporations provide credit facilities on security of demand promissory note or tangible assets such as land, building, insurance policy, gold, jewellery, silverware, motor vehicles and cash crops like spices, raw rubber, etc. In the case of unsecured or clean loans, the period of credit is no more than 90 days, the interest is collected in advance and the borrower is under obligation to repay the loan as the lender demands. There is no such stipulation in the case of a loan secured by assets, and no advance interest is collected on such loans. Extension of loan for 100 to 120 days with recovery on daily basis in equal amounts is very common. The borrowers are mainly merchants with regular sales income, private transport operators, cinema theatre owners, hotel and lodge owners. As the loan is given on the strength of documents, as well as personal assessment made by the lender regarding the social standing and creditworthiness of the borrower, the incidence of bad debts borne by these corporations is insignificant. The banks generally do not lend to the finance corporations. The finance corporations however, place a part of their funds as deposits with commercial banks. They normally seek to reduce the loss on account of default by i) giving loans only to persons or firms personally known to the proprietors or partners, ii) ensuring collective responsibility of all partners in the sanction and recovery of loans, iii) extending loans for usually no more than 90 days and iv) having an instalment system of repayment which minimises the amount outstanding at any time. With the implementation of the Banking Laws (Amendment) Act, 1983, the regulatory powers of the RBI have been extended to all the financial corporations be they firms, proprietary concerns, or unincorporated associations of individuals.

Chit Funds : Under the *chit fund* schemes the promoter of the chitty or kuri collects subscriptions at specified periods from each enrolled member of the chit fund. The amount so collected called the capital of the chitty is given out as the prize amount to one of the members selected either by lot or auction. All members must contribute the periodical subscriptions till the end of the chitty. The promoter, also called the foreman, takes a certain percentage of the capital as his commission. Under the scheme when

a subscriber borrows from the chit fund, he essentially discounts the future value of chit the amount (capital minus the foreman's commission), in order to meet his current needs. The discounted value is the prize amount. The difference between the chit amount and the prize amount is the price the borrower pays for the the borrower pays for the immediate realisation of what would have been due at the expiry of the chit period. The data on the State-wise break-up of chit fund companies indicate concentration of these companies in South India. The region's share in the number of reporting companies as well as chit subscriptions formed about 72 per cent of the total. Among these States, Kerala leads with 28 per cent of the total number of companies and 33 per cent of the total chit subscriptions, followed by Tamil Nadu, Andhra Pradesh and Karnataka. The important characteristics of the working of the chit fund scheme are a) easy access, quick availability of funds, repayment in easy instalments, less rigidity in the matter of security, freedom to utilise the amount for any purpose, b) the cost of credit though higher than that prvoided by banks is not a burdensome factor in view of the unique advantages the scheme confers, c) the funds that flow through chit funds are small in volume and are mostly devoted for consumption and d) distribution of the prize amount is often delayed unduly either because of the delay in or default of instalment payments by subscribers or due to the prize winner's inability to furnish the necessary security or surety in time. This leaves sufficient scope for the foreman to indulge in various malpractices. With the main objective of eliminating the malpractices affecting the scheme, the Chit Funds Act, 1982, came into being. Efforts are being made to bring the Act into force in the various States and Union Territories. These involve making requisite arrangements such as framing rules and setting up of administrative machinery at various levels for effective enforcement of the Act. The Act in the main prescribes the limits on the amount of chits promoted by individuals, partnership firms, co-operative or companies and is aimed at checking the enrolment of bogus subscribers and other malpractices that might be resorted to by the foreman.

Nidhis/Mutual Benefit Funds : These funds represent a group of persons who have agreed to help one another by contributing specified sums to a common fund and extending financial assistance to the needy members. The common fund called the*nidhi*or the mutual benefit fund or the permanent fund may be supplemented by deposits from its members. Profits derived from the operations of the nidhi are shared among its members. Nidhis are registered under the Companies Act, 1956. They are single office institutions and deal exclusively with members; membership is open to all and the shares are transferable. They are popular in South India particularly in Tamil Nadu. Nidhis rely primarily on deposits for their day to day operations. Members can deposit money in savings depo-

sits, recurring deposits (in which nidhis are said to be pioneers), fixed deposits, and cash certificates. In regard to fixed deposits the rate of interest payable ranges between 7 per cent and 14.5 per cent depending upon the period of maturity. The rate of interest on cash certificate varies from 17 per cent on a 3-year deposit to 31 per cent on 7-year deposits. Whereas short-term deposits for less than 3 months could be withdrawn before maturity no withdrawal of fixed deposits of long-term maturity is permitted; members however can borrow against such deposits. Nidhis grant loans to the members against security of recurring deposit or fixed deposit receipts to the extent of 85 to 95 per cent of the value of deposits, against mortgage of buildings, land and house sites within specified jurisdiction, against movable properties such as gold and silver jewellery, Government of India securities, or State Government securities, shares and debentures of companies/postal insurance policies etc. The rate of interest on loans advanced against house property generally ranges between 15 per cent and 18 per cent while the interest charged on advances against members' own deposits is 1 – 1.5 percentage point higher than the contracted rate on such deposits. Although the operations of nidhis are by and large carried on with a high degree of integrity, there are instances of the misuse of powers vested in the Board of Directors in the form of favouritism shown to certain borrowers, appointment of sub-committees to siphon off amounts through sitting fees, conveyance charges, incidental expenses etc. Nidhis are exempted from the State Money Lenders Act and Debt Relief Act and also from the stipulation in regard to ceiling of deposits that can be accepted under the Non-Banking Companies (Reserve Bank) Directions 1977. There is no restriction in regard to the rate of interest or amount of deposits that can be raised from the shareholders. Nidhis confining their operations to specified localities are akin to unit banks, and encourage their members who belong to lower and middle income group to save,and allow them to borrow at reasonable rates of interest to meet their various requirements ranging from defraying of personal expenses, repayment of old debts incurred at higher cost and acquisition or improvement of immovable property.

Hire purchase agencies : The hire-purchase finance scheme under which goods are hired to the user and the seller retains the ownership of goods till the final instalment is paid, was historically confined to road transport industry and was concentrated in the hands of a few individuals and private business houses. Presently in addition to commercial vehicles, purchase of consumer durables like household appliances, air conditioners, and refrigerators, as also two wheelers, office furniture and equipment, is financed under the hire-purchase scheme in a modest way by a number of partnership firms, and proprietary concerns.

The institutions engaged in hire-purchase finance business in the organised sector include commercial banks, the co-operative banks, State Financial Corporations and hire-purchase finance companies, and in the unorganised sector they comprise a large number of partnership firms and individuals. Banks' involvement in this scheme is indirect in the sense they provide refinance to the hire-purchase financiers. The hire charges realised by the hire-purchase financiers in India whether they are limited companies, partnership firms or proprietary concerns are on the basis of flat rates in the sense that the charges are on the entire amount contracted to be financed and not on the diminishing balances or outstandings. Most hire-purchase companies get financial assistance from the commercial banks. The resources of hire-purchases companies and firms consist mainly of external borrowings which have been under regulation of the Reserve Bank from July 1977. Apart from limiting the size of external borrowing the Reserve Bank has prescribed ceilings on the rate of interest and the brokerage payable on deposits.

Loan companies : A company which lends money to any one for purposes other than its own, is classified as a loan company. Hire purchase companies and housing finance companies are not considered as loan companies. Loan companies can be grouped into public limited and private limited companies. The bulk of resources of these companies comprise exempted borrowings not counted as deposits, and public deposits which are in the nature of money received from joint stock companies, shareholders and directors; in the case of government owned corporations like Karnataka Urban Development Corporation or the Kerala State Industrial Enterprises, the exempted borrowings are mainly the funds received from government, banks and other financial institutions. A large number of private limited loan companies are doing no loan business. Loan companies, like other non-banking financial companies are subject to regulation by the Reserve Bank.

Leasing companies : In recent years leasing companies have increased in number and the leasing business is expected to grow considerably over the years. The diversity of equipment currently manufactured in the country and the large number of manufacturing units, particularly in the small scale sector which do not have resources to buy new equipment or which wish to replace existing equipment with more modern equipment provide a good scope for the operation of leasing companies. The advantages of leasing for the lessee are well known but the success of leasing depends crucially on the sound financial structure of the leasing companies and their ability to withstand the impact of fluctuations in the business fortunes of their clients. With the amendment of the Banking Regulation Act, banks have been permitted to undertake leasing business through their subsidiaries

Annexure 6.1

Money Stock and its Components
(New Series)

(Rupees Crores)

As on the Last Friday of March	Currency with the public	Demand Deposits with banks	Other Deposits with RBI	Money Supply with the public/M1	Time Deposits with banks	Aggregate Monetary Resources/ M3
1971	4367	2910	44	7321	3637	10958
1972	4800	3441	79	8320	4370	12690
1973	5420	4213	51	9684	5349	15033
1974	6308	4819	45	11172	6399	17571
1975	6347	5483	78	11907	7553	19457
1976	6704	6385	54	13143	9143	22286
1977	7873	7636	100	15609	11671	27279
1978	8631	5687	70	14388	18518	32906
1979	10212	6843	202	17257	22632	39890
1980	11687	7855	411	19953	26848	46801
1981	13464	9336	317	23117	32241	55358
1982	14492	10087	150	24729	37697	62426
1983*†	16659	11690	186	28535	44333	72868
1984†	19553	13195	316	33064	52833	85897

* Data pertain to March 31.

† Provisional

Note : **Annexures 6.1 to 6.5 are based on data published in the Reserve Bank of India Bulletin,and Report on Currency and Finance (Reserve Bank of India).**

Annexure 6.2

Sources of Money Stock (M_3)
(New Series)

(Rupees Crores)

As on the Last Friday of March	Net bank credit to government	Bank credit to commercial sector	Net foreign exchange assets of the banking sector	Govt.'s currency liabilities to the public	Net non-monetary liabilities of the banking sector	M3
1971	5264	6455	559	384	(1704)	10958
1972	6444	7368	619	411	(2152)	12690
1973	7770	8729	577	457	(2500)	15033
1974	8726	10701	674	502	(3032)	17571
1975	9533	12671	489	531	(3766)	19457
1976	10112	15392	1147	555	(4919)	22286
1977	11019	18503	2525	567	(5335)	27279
1978	13470	21221	4499	593	(6878)	32905
1979	15391	25347	5420	603	(6871)	39890
1980	19230	30633	5401	592	(9055)	46801
1981	24731	36235	4616	619	(10843)	55358
1982	30139	42912	2530	657	(13812)	62426
1983*†	34748	51161	1684	682	(15407)	72868
1984†	40505	59992	1580	719	(16899)	85897

* Data pertain to March 31.
† Provisional.

Annexure 6.3

Reserve Money and its Components **(Rupees crores)**

As on 31st March	Currency with the public	Other Deposits with RBI	Cash with banks	Bankers' deposits with RBI	Reserve Money
1951*	1367	24	39	59	1489
1961*	2098	13	50	71	2232
1971	4371	60	186	206	4823
1972	4801	80	205	296	5381
1973	5438	58	242	295	6033
1974	6321	53	274	625	7273
1975	6347	75	354	828	7604
1976	6705	77	348	678	7807
1977	7873	121	415	1389	9798
1978	8631	70	521	1719	10941
1979	10231	166	604	3081	14083
1980	11654	391	728	3800	16573
1981	13426	411	881	4734	19452
1982	14474	168	937	5419	20998
1983	16659	186	980	5285	23110
1984	19602	291	1040	8060	28993

* *As on the last Friday of March.*

Annexure 6.4

Sources of Reserve Money **(Rupees Crores)**

As on 31st March	Reserve Bank's Claim on: Government (net) $	Commercial & Co-operative Banks @	NABARD	Commercial sector*	Net foreign exchange assets of RBI	Govt's Currency Liabilities to the public	Net Non-Monetary Liabilities of RBI	Reserve Money @
1951£	461	58	-	1	878	241	150	1489
1961£	1898	185	-	9	185	206	250	2232
1971	3843	642	-	132	530	384	709	4823
1972	4870	531	-	232	608	411	1271	5381
1973	5696	480	-	266	569	457	1435	6033
1974	6460	731	-	560	661	502	1641	7273
1975	7. 1	981	-	663	369	531	2061	7604
1976	6924	1315	-	734	924	555	2645	7807
1977	7765	1404	-	898	2599	568	3433	9798
1978	7644	926	-	954	4532	593	3708	10941
1979	9416	1117	-	1250	5431	604	3735	14083
1980	11804	1200	-	1546	5388	592	3957	16573
1981	15853	1276	-	1700	4775	619	4770	19452
1982	19989	1673	-	2044	2706	657	6070	20998
1983	22314	873	1152	1925	1729	682	5565	23110
1984	26719	1553	1218	2380	1624	719	5221	28993

* Represents investments in shares/bonds of financial institutions, loans to them and holding of internal bills purchased and discounted. Excludes, since the establishment of NABARD, its refinance to banks.

@ Reserve money as shown in the last column is obtained by subtracting net non-monetary liabilities of RBI from the sum of other sources of reserve money.

£ As on the last Friday of March.

$ RBI's claims on government (gross) less deposit balances held by government with RBI.

Annexure 6.5

Monetary Ratios

Last Friday of March	M_3/RM	C/M_3	C/M_1	C/AD	C/TD	DD/TD	BR/AD	Income velocity of M_3*
1950-51	1.536	0.598	0.692	1.526	4.395	1.881	0.109	3.86
1955-56	1.602	0.586	0.709	1.424	3.371	1.137	0.086	3.46
1960-61	1.776	0.529	0.731	1.133	1.916	0.691	0.065	3.35
1965-66	1.898	0.495	0.670	0.984	1.890	0.921	0.058	3.36
1970-71	2.276	0.399	0.597	0.667	1.201	0.800	0.062	3.12
1975-76	2.882	0.301	0.510	0.432	0 733	0.698	0.063	2.79
1980-81	2.946	0.243	0.582	0.324	0.418	0.290	0.120	1.91
1983-84	2.980	0.228	0.591	0.296	0.370	0.250	0.136	1.86

C = Currency with the public; AD = Aggregate deposits with banks; TD = Time deposits with banks; DD = Demand deposits with banks; BR = Bankers deposits with RBI plus Cash with banks; RM = Reserve Money

* Ratio of Net National Product at factor cost at current prices to M_3.

Source : Computed from data published in Report on Currency and Finance (Reserve Bank of India).

Index Numbers of Wholesale Prices in India

(1970-71 = 100)

April-March (Average of Months)	All Commodities	Primary articles		Fuel, Power, Light & Lubricants	Manufactured Products
		Total	Foodgrains		
	(100.0)	(41.67)	(12.92)	(8.46)	(49.87)
1950-51	47.5	46.8	51.4	46.0	47.7
1951-52	50.4	48.8	51.0	47.5	51.4
1952-53	44.1	40.4	48.2	50.7	46.6
1953-54	46.2	42.3	46.5	50.5	48.9
1954-55	43.0	38.3	36.5	50.5	47.3
1955-56	40.8	36.1	35.2	49.3	44.9
1956-57	46.5	41.9	45.0	52.9	50.1
1957-58	47.9	43.2	47.0	57.6	51.4
1958-59	49.8	45.6	51.2	59.0	52.3
1959-60	51.7	47.0	49.2	59.6	55.0
1960-61	55.1	49.6	49.3	61.2	59.5
1961-62	55.2	49.5	48.4	62.3	60.2
1962-63	57.3	51.1	51.0	64.4	62.8
1963-64	60.9	53.8	55.7	73.7	66.4
1964-65	67.5	64.1	70.4	74.9	70.0
1965-66	72.7	70.4	74.6	77.2	74.4
1966-67	82.8	82.0	88.4	83.2	83.4
1967-68	92.4	92.4	110.4	88.0	92.7
1968-69	91.3	89.7	97.2	92.2	92.8
1969-70	94.8	96.2	100.7	96.1	93.1
1970-71	100.0	100.0	100.0	100.0	100.0
1971-72	105.6	100.9	103.4	105.9	109.5
1972-73	116.2	110.7	119.5	110.1	121.9
1973-74	139.7	141.8	141.9	130.6	139.5
1974-75	174.9	177.5	195.8	198.3	168.8
1975-76	173.0	165.8	174.1	219.2	171.2
1976-77	176.6	167.2	152.7	230.8	175.2
1977-78	185.8	183.8	170.4	234.3	179.2
1978-79	185.8	181.4	172.6	244.7	179.5
1979-80	217.6	206.5	185.4	283.1	215.8
1980-81	257.3	237.5	216.7	354.3	257.3
1981-82	281.3	264.4	237.4	427.5	270.6
1982-83	288.6	273.9	248.8	458.7	272.1
1983-84+	315.3	304.0	273.2	490.0	295.1

+ Provisional.

Figures within brackets indicate we[illegible]

Sources : H. L. Chandhok, Wholesale Price Statistics (Economics and Scientific Research Foundation, New Delhi).
Report on Currency & Finance (Reserve Bank of India).
Reserve Bank of India Bulletin.

Major Monetary Regulation Measures, 1970-85

1970–71

(1) Bank Rate was raised from 5 per cent to 6 per cent in January 1971.
(2) Statutory Liquidity Ratio (SLR) was raised from 26 per cent to 27 per cent in April 1970, and to 28 per cent in August 1970.
(3) Net Liquidity Ratio(NLR)was raised from 31 per cent to 32 per cent in April 1970, and to 33 per cent in August 1970 and to 34 per cent in January 1971.

1972–73

(1) SLR was raised from 28 per cent to 29 per cent in August 1972 and to 30 per cent in November 1972.
(2) NLRwas stepped up to 36 per cent in November 1972 and 37 per cent in March 1973.

1973–74

(1) Bank Rate was raised from 6 to 7 per cent in May 1973. Penal rates on borrowings from RBI were raised.
(2) Cash Reserve Ratio (CRR) was raised from 3 per cent to 5 per cent in June 1973 and further to 6 per cent and then to 7 per cent in September 1973.
(3) SLR was raised to 32 per cent in December 1973.
(4) NLRwas raised to 39 per cent in June 1973 and further to 40 per cent in September 1973.
(5) Minimum lending rate of commercial banks was stipulated at 10 per cent in June 1973 and raised to 11 per cent in December 1973.
(6) Quantitative credit ceiling were imposed for the busy season.
(7) Selective credit control – margins and minimum rate of interest on advances in respect of sensitive commodities were modified.
(8) Marginal upward readjustments in the rates of interest on term deposits of certain maturities done in April 1973.

1974–75

(1) Bank rate was raised from 7 per cent to 9 per cent in July 1974.
(2) CRR was reduced to 5 per cent in June 1974 and to 4.5 per cent and then to 4 per cent in December 1974.
(3) Interest rates on savings and fixed deposits were raised in April 1974 and again in July 1974.
(4) Minimum lending rates chargeable by commercial banks on advances

against commodities subject to selective credit control and also other commodities raised.

(5) SLR raised from 32 to 33 per cent in June 1974.

(6) NLR was reduced to 39 per cent in December 1974.

1975–76

(1) Overall expansion of bank credit was required to be limited to 63-64 per cent of accretion to deposits of banks during 1975-76 (May-April).

(2) NLR was discontinued from November 1975.

(3) Banks were advised to provide medium-term finance for projects in selected areas.

(4) Ceiling rate on commercial bank advances was fixed at 16.50 per cent from March 1976.

1976–77

(1) CRR was raised from 4 per cent to 5 per cent in September 1976 and further to 6 per cent in November 1976.

(2) From January 1977, in addition to the CRR, banks were required to deposit with the RBI 10 per cent of their incremental net demand and time liabilities accruing since January 14, 1977 as additional.

1977–78

(1) The impounding of 10 per cent of incremental demand and time liabilities of commercial banks continued.

(2) Deposit rates of banks were rationalised. The rate of interest on saving deposits was reduced from 5 per cent (except for those without cheque facility) and in respect of fixed deposits for over 3 months and upto 5 years by 1-2 per cent.

(3) Ceiling rate on commercial bank advances was reduced to 15 per cent from March 1978.

1978–79

(1) SLR was raised from 33 per cent to 34 per cent in December 1978. This ratio applied to incremental deposits regardless of excess assets held at the time.

(2) Banks were advised to limit the gross non-food credit expansion to 40 per cent of growth in deposits.

(3) Banks defaulting on their CRR/SLR requirements would be allowed refinance/rediscount facilities only after correcting their defaults.

(4) Additional one-half of the net aggregate amount received under the Non-Resident (External) Rupee Account and Foreign Currency (Non-Resident) Account Schemes impounded.

1979–80

(1) The impounding of deposits relating to non-resident deposit schemes was discontinued in June 1979 but the already impounded amounts were not released.
(2) From the last Friday of July, participation certificates were treated as deposits and came under the CRR and SLR regulation.
(3) Deposit rates of banks were raised marginally from September 1979.
(4) Maximum lending rate on short term advances was increased from 15 per cent to 18 per cent for large banks and from 16 per cent to 19 per cent for smaller banks from September 1979. Commodities subject to selective credit control was also governed by this directive.

1980–81

(1) Following the reimposition of interest tax on banks, the minimum lending rate of scheduled commercial banks was raised from 12.5 per cent to 13.5 per cent and the maximum rate was raised from 18.0 per cent to 19.4 per cent in July 1980. The maximum lending rate was fixed at 19.5 per cent in March 1981 for banks of different sizes.
(2) Incremental CRR was withdrawn from October 31, 1980.
(3) Deposit rates were raised. The maximum deposit rate was fixed at 10 per cent for maturities exceeding 3 years (March 1981).

1981–82

(1) CRR was raised from 6.0 per cent to 6.5 per cent in July 1981 and to 7.0 per cent in August 1981 and to 7.25 per cent from November 1981 to 7.50 per cent in December 1981 and still further to 7.75 per cent in January 1982.
(2) Bank rate was raised from 9 per cent to 10 per cent in July 1981.
(3) SLR was raised from 34 per cent to 34.5 per cent in September 1981 to 35 per cent in October 1981.
(4) Interest rate on bank deposits of less than 3 years maturity were marginally raised.

1982–83

(1) CRR was reduced from 7.75 per cent to 7.25 per cent. In respect of non-resident external rupee accounts the CRR was reduced to 3 per cent, the statutory minimum (April 1982). CRR was further reduced from 7.25 per cent to 7.00 per cent of net demand and time liabilities effective from June 11, 1982.
(2) Category of term deposits of maturity of 5 years and above was revived, carrying an interest rate of 11 per cent with effect from October 26, 1982.
(3) The maximum lending rate of scheduled commercial banks was reduced to 18 per cent.

(4) Some adjustments were made in the refinance formule.
(5) Liberalisations were made in the procedures of Credit Authorisation Scheme.

1983–84

(1) CRR was raised from 7.00 per cent to 7.5 per cent in May 1983 and again from 7.5 per cent to 8.00 per cent in July 1983 and from 8.0 per cent to 8.5 per cent in August 1983 and from 8.5 per cent to 9.00 per cent in February 1984.
(2) From November 1983 banks were required to maintain an incremental cash reserve ratio of 10 per cent of the increase in net DTL over the level as on November 11, 1983.

1984–85

(1) SLR was raised from 35 per cent to 36 per cent in two phases – to 35.5 per cent with effect from July 28, 1984 and to 36 per cent effective September 1, 1984.
(2) Onefifth of the additional cash balance maintained by the scheduled commercial banks as on October 31, 1980 pursuant to the 10 per cent incremental cash reserve ratio introduced in January 1977 was released in two equal instalments in October and December 1984.
(3) Prior authorisation by the Reserve Bank is required for granting either singly or jointly with other banks, individual term loans (of more than three years) exceeding Rs. 50 lakhs to a private sector borrower and Re. 1 crore to a public sector borrower or a private sector export oriented manufacturing unit.
(4) Reserve Bank announced the mode of valuation of securities for purposes of the SLR requirement with effect from March 29, 1985.

April, 1985

(1) With effect from April 8, 1985 within a prescribed rate of interest of 8 per cent, for maturities less than one year, individual bank, are allowed to fix rates on other maturities from 15 days and above. The deposit rate for one year and over but less than two years is raised from 8.0 per cent to 8.5 per cent.
(2) Selective credit controls was rationalised with effect from April 8, 1985.

Annexure 9.1

Money, Output and Prices

(Rupees Crores)

Year ending March	Net National Product at factor cost		M_3†	Index Numbers of Wholesale Prices @
	at 1970-71 prices	at current prices		
1950-51	16731	8812	2287	47.5
1951-52	17086	9141	2137	50.4
1952-53	17699	8920	2121	44.1
1953-54	18854	9582	2200	46.2
1954-55	19328	8716	2379	43.0
1955-56	19953	9262	2683	40.8
1956-57	21046	10696	2869	46.5
1957-58	20587	10691	3163	47.9
1958-59	22329	12008	3476	49.8
1959-60	22676	12402	3883	51.7
1960-61	24250	13263	3964	55.1
1961-62	25039	13987	4243	55.2
1962-63	25414	14795	4553	57.3
1963-64	26746	16977	5037	60.9
1964-65	28808	20001	5499	67.5
1965-66	27103	20637	6134	72.7
1966-67	27298	23848	6817	82.8
1967-68	29715	28054	7460	92.4
1968-69	30513	28607	8306	91.3
1969-70	34208	31606	9337	94.8

Annexure 9.1

Money, Output and Prices (contd.)

(Rupees Crores)

Year ending March	Net National Product at factor cost		M_3†	Index Numbers of Wholesale Prices @
	at 1970-71 prices	at current prices		
1970-71	34235	34235	10958	100.0
1971-72	34715	36573	12690	105.6
1972-73	34191	40270	15033	116.2
1973-74	35967	50424	17571	139.7
1974-75	36502	59446	19457	174.9
1975-76	40064	62069	22286	173.0
1976-77	40271	66754	27279	176.6
1977-78	43918	75479	32905	185.8
1978-79	46398	81195	39890	185.8
1979-80	43830	88506	46801	217.6
1980-81	47312	105834	55358	257.3
1981-82	49631	120806	62426	281.3
1982-83	50437	132470	72868£	288.6
1983-84*	54276	159598	85897	315.3

* Provisional

† As on the last Friday of March

@ All commodities (average of months); base 1970-71 = 100.

£ Data pertain to March 31

Sources : National Accounts Statistics (Central Statistical Organisation, Government of India).
Report on Currency and Finance (Reserve Bank of India)
H. L. Chandok, Wholesale prices in India (Economic and Scientific Research Foundation, New Delhi).

Annexure 9.2

Money, Output and Prices : Annual Variations*

(per cent)

Year ending March	Net National Product at factor cost		M_3	Index Numbers of Wholesale Prices @
	at 1970-71 prices	at current prices		
1951-52	2.1	3.7	(–)6.6	6.1
1952-53	3.6	-2.4	(–)0.8	(–)12.5
1953-54	6.5	7.4	3.7	4.8
1954-55	2.5	-9.0	8.1	(–)6.9
1955-56	3.2	6.3	12.8	(–)5.1
1956-57	5.5	15.5	6.9	14.0
1957-58	(–)2.2	-0.1	10.2	3.0
1958-59	8.5	12.3	9.9	4.0
1959-60	1.6	3.3	11.7	3.8
1960-61	6.9	6.9	2.1	6.6
1961-62	3.3	5.5	7.0	0.2
1962-63	1.5	5.8	7.3	3.8
1963-64	5.2	14.7	10.6	6.3
1964-65	7.7	17.8	9.2	10.8
1965-66	(–)5.9	3.2	11.5	7.7
1966-67	0.7	15.6	11.1	13.9
1967-68	8.9	17.6	9.4	11.6
1968-69	2.7	2.0	11.1	(–)1.2
1969-70	6.2	10.5	12.4	3.8
1970-71	5.6	8.3	17.4	5.5
1971-72	1.4	6.8	15.8	5.6
1972-73	(–)1.5	10.1	18.5	10.0
1973-74	5.2	25.2	16.9	20.2
1974-75	1.5	17.9	10.7	25.2
1975-76	9.8	4.4	14.5	(–)1.1
1976-77	0.5	7.5	22.4	2.1
1977-78	9.1	13.1	20.6	5.2
1978-79	5.6	7.6	21.2	0.0
1979-80	(–)5.5	9.0	17.3	17.2
1980-81	7.9	19.6	18.3	18.2
1981-82	4.9	14.1	12.8	9.3
1982-83	1.6	9.7	16.7	2.6
1983-84	7.6	20.5	17.9	9.2

* Computed from data presented in Annexure 9.1.

Annexure 11.1

REPORT OF THE STUDY GROUP TO FRAME GUIDELINES FOR FOLLOW-UP OF BANK CREDIT – R.B.I. (1975)

(Chairman : Shri Prakash Tandon)

SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

1. Till nationalisation of the major commercial banks in July 1969, the main contenders for bank credit were large and medium scale private industry and internal and external trade. Nationalisation called for a new policy and the banking system was asked to adopt a new approach as a credit agency, based on development and potential rather than on security only, to assist the weaker sectors of the society, and later to lend to the public sector also (Paragraphs 1.1 and 1.2)

2. In the early years, bank lending in India was mostly directed to financing of movement of agricultural produce from the grower to the trader. Advances were sanctioned against the security of stocks charged to the banks. With the growth of industrialisation, the same system of bank lending continued with minor changes, the general pattern of lending to industry being security-cum-guarantee advances. The security-oriented system tended to favour borrowers with strong financial resources, irrespective of their economic function. This system aided concentration of economic power (Paragraphs 3.1 to 3.3).

3. Since nationalisation, there has been a new sense of direction in bank lending and indeed advances to new claimants of credit, and especially to small industry and agriculture, have since gone up. The public sector too has emerged as an important user of credit in recent years. Another new source of demand is the growing awareness of the need to achieve an equitable geographical development of industry, and in its wake the distribution of credit (Paragraphs 3.6 to 3.8).

4. In the last six or seven years, industrial production has risen at a slow pace but the call on bank credit essentially for maintaining inventories even at the same level, has gone up with in-creasing prices. If the growth process is resumed – as indeed it has begun to do-then perforce the volume of inventory required to maintain a higher level of production will increase and correspondingly the demand for bank credit. Banks will thus have to operate in a context in which demand for bank credit for growth requirements will be large (Paragraph 3.10).

5. The problem of potential imbalance in demand for and supply of funds is accentuated by the manner in which banks extend credit under the present cash credit system of lending. Under this system, the level of advances in a bank is determined not by how much a banker can lend at a particular point of time but by the borrower's decision to borrow at that time. This makes credit planning difficult in banks. Also, cash credit advances are repayable on demand only in name. To the extent that outstandings in the cash credit account never fell below a certain level during the course of year, there is an element of what is called a 'hard core' borrowing which is in reality a quasi-permanent lock up of bank funds in the borrower's business (Paragraphs 3.12 to 3.20).

6. In the light of the foregoing, time is now opportune to review the existing system and effect changes in such a way that under the new system the borrower would plan his credit needs and the banker also would be able to plan, having known the borrower's credit requirements (Paragraphs 3.22 and 3.23).

7. A borrower needs funds for the operation, mainly to carry current assets required for the purpose. Inventory and receivables comprise the bulk of the current assets. There is no uniformity in approach among banks in assessing working capital requirements, especially with regard to inventories. If bank credit is to be viewed as a tool of resource allocation in the eco-

nomy, one cannot get away from the problem of defining reasonable levels of inventories (including safety stock) and receivables in each industry and hence the need for norms for these current assets (Paragraphs 4.1, 4.2 and 4.7).

8. In the new context, the main function of a banker as a lender is to supplement the borrower's resources to carry an acceptable level of current assets. The implications are two-fold: one, the level of current assets must be reasonable and based on norms; two, a part of the fund requirements for carrying current assets must be found from long term funds comprising owned funds and term borrowings including other non-current liabilities (Paragraph 4.8).

9. Norms have been suggested for 15 major industries, taking into account, inter alia, company finance studies made by the Reserve Bank, process period in the different industries, discussions with the industry experts and feed-back received on the Interim Report. The norms proposed represent the maximum levels for holding inventory and receivable in each industry. If, however, a borrower has managed with less in the past, he should continue to do so (Paragraphs 5.7 and 5.8).

10. In view of the special characteristics of the heavy engineering industry, particularly the large tie-up of funds in current assets, the banking system may find it difficult to cope with the industry's demand for funds in its entirety. The working capital requirements of the heavy engineering sector should, therefore, be assessed taking into account the alternative ways of financing the needs and the extent to which banks may meet them may be determined, case by case, on merits (Paragraphs 5.9 to 5.11).

11. Norms cannot be absolute or rigid. Deviations from norms may be visualised under certain circumstances, e.g., bunched receipt of raw materials, power cuts, strikes, transport delays, etc. However, delayed payments by Government agencies and sometimes by large units in the private sector cannot be treated as circumstances warranting deviations and the matter should be tackled at the sources rather than throwing upon the banking system the burden of providing additional credit. The Reserve Bank should discuss the matter with Government agencies and the Bureau of Public Enterprises; Government and public enterprises should set an example in prompt payments (Paragraphs 5.12 and 5.13).

12. Concessions under the criteria for deviating from norms should not be expected as a matter of course but must be fully justified. Deviations should be for known specific circumstances and situations (which should be recorded) and allowed for agreed periods which should be relatively short; and there should be a return to norms when conditions revert to normal (Paragraph 5.14 and 5.15).

13. Norms should apply to all industrial borrowers, including small scale industries, with aggregate limits from the banking system in excess of Rs. 10 lakhs and extended to smaller borrowers progressively as early as possible (Paragraph 5.16).

14. In the case of industries not covered by norms at present, the purpose and spirit behind the norms should be kept in view when extending credit facilities (Paragraph 5.17).

15. The list of industries covered by norms should be extended with experience. Norms should be kept under constant review (Paragraphs 5.18 & 5.21).

16. The principles should be uniform for all like industries both in the private and public sectors. Thus, public sector industry should conform to the same norms as are applicable to comparable private industry, though in special cases, norms may have to be relaxed, but after a study in depth (Paragraph 5.19 and 12.23).

17. All credit limits, whether enhancement is sought for therein or not, should be considered in the light of the norms and where the levels of inventory and receivables are excessive, they should be reduced, bringing down also the dues to the bank and/or other creditors (Paragraph 5.20).

18. The process of adjustment of inventories and receivables should be completed in about two months, other things being equal. In the event of default, as a first step, the bank should charge a higher rate of interest. But even charging of a higher rate of interest should not give a permanent immunity to the customer from conforming to norms and some further action should be considered (Paragraph 5.20).

19. The working capital gap, viz. the borrower's requirement of finance to carry current assets (based on norms) other than those financed out of his other current liabilities, could be bridged partly from his owned funds and long–term borrowings and partly by bank borrowings (Paragraph 6.2).

20. The maximum permissible level of bank borrowings could be worked out in three ways. In the 1st Method, the borrower will have to contribute a minimum of 25% of the working capital gap from long term funds, i.e. owned funds and term borrowings; this will give a minimum current ratio of 1:1. In the 2nd Method, the borrower will have to provide a minimum of 25% of total current assets from long term funds; this will give a current ratio of at least 1.3:1. In the 3rd Method, the borrower's contribution from long term funds will be to the extent of the entire core current assets, as defined, and a minimum of 25% of the balance current assets, thus strengthening the current ratio further (Paragraph 6.3 to 6.8).

21. The classification of current assets and current liabilities for computing the permissible level of bank finance should be made as per the usually accepted approach of bankers (Paragraph 6.9).

22. The 3rd Method will provide the largest multiplier of bank finance, however, to avoid hardship to borrowers, a beginning may be made with the 1st Method, placing all borrowers in this method within a period of about one year, and the ideal of the 3rd Method may be reached in stages. The liberal approach under the 1st Method has been suggested as the first step, particularly to facilitate financial structuring of new companies, setting up projects in backward areas and also for flexibility in restructuring of existing companies with a weak financial base (Paragraphs 6.10 & 6.12).

23. The aim should be to move forward and borrowers in the third or second category should not revert to the second or first category respectively by increasing their dependence on bank borrowings. Also, when credit needs increase, the borrower should not slip back from a higher to a lower category (Paragraph 6.12).

24. Banks will work out the position of existing customers and any excess over the finance, to which a borrower would be eligible under the new formula, will have to be reduced progressively, by transferring the excess to a term loan, amortised over a suitable period (Paragraph 6.13).

25. The concept of bank credit forming only a portion of the working capital gap could also be used as an instrument for influencing the directional flow of credit, according to the priorities for industries indicated by the authorities concerned from time to time by varying the scales if finance. Also, when a manufacturer has reached a stable level of production for a reasonable number of years, there is no reason why bank finance should continue to be made available to him on the same scale, because if a portion of the finance made available to him could be withdrawn, such funds would be available for promotion of new economic activity. (Paragraph 6.14).

26. In future, while funding new projects, the term lending institutions may provide for margins on the basis of recommended proposals and the bank which is to finance the working capital requirements should be associated at this stage in determining the working capital and margin requirements. In the case of old units, where a part of the present cash credit borrowing is transferred to a term loan, to bring the borrowings in line with the recommended proposals, the funded debt and equity relationship may not immediately conform to the

norms of the term lending institutions. In these cases, borrowers may have to be given time to bring the position to normal, but the total outside liabilities to owned funds relationship will have to be acceptable to the banks (Paragraphs 6.15 & 6.16).

27. A request for additional credit on a regular basis from a borrower who already has an excess borrowing under any of the three methods may be considered provided the borrower brings in matching contribution required under the relevant method of lending. In very exceptional cases, however, if the cash generating capacity of the borrower is sufficiently good, banks may grant a term loan for the purpose to a reasonable extent for a short period acceptable to the bank. If, however, the additional fund need is for a short duration for specific transactions/contracts, the bank may consider giving additional credit for such needs without insisting on matching contribution, on the clear understanding that the borrower would return to the stage as in the relevant method of lending within the stipulated period. Borrowers having excess borrowing in relation to inventory norms will not be eligible for additional limits on a regular basis until such time as the current assets are brought down to the required levels (Paragraphs 6.17 and 6.18).

28. The annual credit limit may be bifurcated into a loan, which would comprise the minimum level of borrowing throughout the year, and a demand cash credit, which would take care of the fluctuating requirements, both to be reviewed annually. There should, however, be no rigidity in the matter of bifurcation of the overall credit limit between loan and cash credit (Paragraphs 6.22, 6.23 and 7.1).

29. In the case of industries with a very high degree of seasonality, assessment of bank finance may have to be done on the basis of monthly cash budgets (Paragraph 6.24).

30. The demand cash credit should be charged a slightly higher interest rate than the loan component. This approach will give the borrower an incentive for good planning. The term loan representing the excess borrowing to be amortised should also be at a slightly higher rate than the cash credit rate (Paragraph 6.25).

31. In order to ensure that customers do not use the new cash credit facility in an unplanned manner, the financing should be placed on a quarterly budgeting-reporting system for operational purposes, as in the suggested forms (Paragraph 6.26 and 6.27).

32. The borrowers expressed concern about the secrecy and sensitiveness of the information proposed to be called for from them. Banks are expected to take due notice of their apprehension (Paragraph 6.29).

33. Apart from loan and cash credit, a part of the total credit requirement, within the overall eligibility could also be provided by way of bill limits to finance seller's receivables. It is desirable that, as far as possible, receivable should be financed by way of bills rather than cash credit against book debts. As regards the question whether purchases may be financed by way of cash credit of bills, each bank may take its own decision in consultation with the borrower, keeping in view the size of his operations, the individual transaction and the administrative set up obtaining in the bank (Paragraphs 6.30 and 6.31).

34. The proposed system of lending and the style of credit may be extended to all borrowers having credit limits in excess of Rs. 10 lakhs from the banking system, while the information system may be introduced, to start with, in respect of borrowers with limits of Rs. 1 crore and above from the entire banking system and then extended progressively to others (Paragraph 6.32).

35. The mechanics of lending suggested covers examination of the borrower's total operational plan as also his past and current financial position. The borrower should, therefore, furnish to the banker an operating statement and funds flow statement for the whole year (i.e. the next year) as also projected balance sheet as at the end of the next year, along with the

application for advance or renewal, for fixation of the overall credit limit (Paragraph 7.1).

36. The working capital gap will be computed, the extent of bank finance will be arrived at and the overall credit limit will be fixed, on the basis indicated in Chapter 6 (Paragraph 7.1)

37. Actual drawings within the sanctioned limit will be determined by the customer's inflow and outflow of funds as reflected in the quarterly funds flow statement and the permissible level of drawing will be the level as at the end of the previous quarter plus or minus the deficit or surplus shown in the funds flows statement (Paragraph 7.1).

38. Within the overall permissible level of drawing, the day-to-day operations in the account will be regulated on the basis of drawing power (subject to the margins stipulated by the banker against the different components of inventory and receivables), as per the monthly stock statements, which will continue to be submitted (Paragraph 7.1).

39. Variances are bound to arise in any budget or plan; variances to the extent of say = 10 per cent should be permissible, and beyond this, the banker and customer should discuss the reasons (Paragraph 7.1).

40. The recommendation regarding inventory/receivables norms and the mechanics of lending are to be viewed as a package; it is an integrated scheme and the borrower is expected to subject himself to the entire discipline envisaged (Paragraph 7.3).

41. A bank has to follow up and supervise the use of credit to verify first, whether the assumptions of lending in regard to borrower's operations continue to hold good and second, whether the end-use is according to the purpose for which the credit was given (Paragraph 8.1).

42. If the banker is to get away from security-oriented lending to production-related credit with security serving a subsidiary but necessary role, he will have to be in close touch with the borrower's operations. Since projected funds flow statement would form the basis for determining the line of credit, a banker would be justified in laying down a condition that any material change, say around 10 per cent of the figure projected earlier, would require his prior approval. Thus, the banker may stipulate certain minimum terms and conditions relating to matters having a material impact on the funds flow of the borrower (Paragraphs 8.4 to 8.6).

43. From the quarterly forms, the banker will verify whether the operational results conform to earlier expectations and whether there is any divergence reading as red signals; however, variance of, say around 10 per cent, may be treated as normal (Paragraph 8.8).

44. In addition to the quarterly data, the larger borrowers should submit a half-yearly proforma balance sheet and profit and loss account within two months of the end of the half-year (Paragraph 8.9).

45. In the new system, it is in the borrower's own interest that audited balance sheets are produced as early as possible, say, in three months, and he should take positive steps in this direction (Paragraph 8.10).

46. After the close of each year, detailed credit analysis should be done as in respect of new advances, when the banker will re-examine the terms and conditions and make necessary changes (Paragraph 8.11).

47. Stock statements will continue to be submitted but they need to be improved. The basis of valuation in the stock statements and the balance sheet should be uniform. The stocks should be reconciled in the stock statements, showing the opening and closing stocks, quantity-wise and value-wise (Paragraphs 8.12 and 8.13).

48. Stock inspection poses problems particularly in large industries. In such cases, there is no alternative to depending on financial follow-up. Where a banker feels, for special reasons, that a detailed stock verification is called for, a regular stock audit may have to be arranged with the assistance of outside consultants (Paragraph 8.15).

49. Managerial competence is an important factor in the efficiency of operations, reflected in profitability and working capital and financial management. Banker should keep in mind that appraisal of management may be essential particulary as we place a new emphasis on viability and development rather than on security alone (Paragraph 8.17).

50. To facilitate inter-firm and industry-wise comparisons for assessing efficiency, it would be of advantage if companies in the same industry could be grouped under three or four categories, say, according to size of sales and the group-wise financial ratios compiled by the Reserve Bank for furnishing to banks (Paragraph 8.18).

51. Industry organisations should also collect data from their members and publish whole-industry balance sheets, profit and loss accounts and relevant ratios (Paragraph 8.19).

52. In making inter-firm comparisons, besides examining financial and operating ratios, certain productivity ratios may also be examined to determine labour efficiency, capital efficiency and fixed assets efficiency (Paragraph 8.20).

53. For the purpose of better control, there should be a system of borrower classification in each bank. This will facilitate easy identification of the borrowers whose affairs require to be watched with more than ordinary care and will also provide a rational base for purposes for fixing rates of interest for the respective borrowers (Paragraph 8.22).

54. The only feasible manner in which the banker can satisfy himself in regard to end-use of funds would be to ensure, by calling for appropriate operational data and figures relating to financial position at periodical intervals, that the borrower's current ratio and the respective shares of bank finance and borrower's long term funds in meeting his working capital gap do not change adversely; if the position in this regard does not change adversely, the conclusion would be that bank finance has gone towards build-up of current assets (Paragraph 8.26).

55. Apart from the current ratio, the bank will look to the debt-equity ratio, which may be looked at as funded debt-equity relationship or total outside liabilities – equity relationship. It is not practicable to legislate absolute standards for these ratios. Where the debt-equity ratios of a borrower are worse than the median for his industry, the banker would endeavour to persuade the borrower to strenthen his equity as early as possible and the latter should pursue to reach the median on the basis of the data up-dated by the Reserve Bank (Paragraphs 9.1 to 9.9).

56. The change-over recommended should be effected with a minimum of inconvenience to the banker and the customer. Borrowers suggested that banks should reduce tiers and take quicker decision. This is a matter for each bank to examine in relation to its own administrative systems and procedures and take appropriate action. There should be total commitment of the top management in each bank to the new approach. Extensive training facilities in credit appraisal should be provided for bank staff at all levels, with particular emphasis on the suggested information system and handling of inventory and receivables norms (Paragraphs 10.1 to 10.5).

57. A customer can no longer take a stand that having given security, there is no necessity for him to give any data to banks. There are rights and obligations on both sides. The banker as the lender is entitled to information which he deems necessary for his appraisal and follow-up and also has a duty in turn towards the borrower to appreciate his difficult situations. On the same basis, the customer should also develop an accountability to his banker (Paragraphs 11.2 to 11.4).

58. While financing trade, banks should keep in view, inter alia, the extent of owned funds of the borrower in relation to the credit limits granted, the annual turnover, possible diversion to other units or uses and how much is being ploughed back from profits into the business. They should avoid financing of goods which have already been obtained on credit (Paragraph 12.2).

59. It will be useful if Government authorities like the Textile Commissioner or Jute Commissioner consult the Reserve Bank before prescribing stock levels for the industries concerned to the extent these may cut across the relative norms for inventory holding (Paragraph 12.4).

60. In view of the need for efficient transportation and availability of wagons, railways should assume some liability for undue delays as a part of their own discipline, as they do for damages in transit at railway risk (Paragraph 12.5)

61. The canalising agencies and public sector producers may review, from time to time, their distribution procedures so as to prevent unproductive lock-up of bank funds (Paragraphs 12.6 and 12.7).

62. Government and the public sector are the biggest buyers in the country and tardy payments by them will only increase the level of receivables and, consequently, the need for bank credit. Government departments have already been following the accepted commercial practices in respect of their purchases from foreign suppliers but not in respect of their internal purchases. It will be useful if the Reserve Bank could initiate discussions on this matter. Further, Government should, pending streamlining its procedures, agree to pay interest on established delayed payments (Paragraph 12.8).

63. The possibility of switching over from credit sales to cash sales, wherever possible, both in the private and the public sectors, should be examined, or at least credit period allowed by sellers should be progressively reduced, in order to shorten the transaction cycle and enable bank funds to achieve a larger multiplier (Paragraph 12.9).

64. In the case of consortium advances or where a borrower is financed by more than one bank, the concerned banks should evolve a procedure to ensure a uniform handling of the account in conformity with the inventory and receivables norms and the financial discipline suggested (Paragraph 12.10).

65. If a borrower refuses to comply with the new requirements, there will be no alternative to the banker but to take first a holding action by raising the rate of interest until such time as the requirements are fulfilled; but if this fails, the banker will have no option but to stop operations in the account (Paragraphs 12.11 and 12.12).

66. Once danger signals are thrown up in the case of a borrower and signs of difficulty emerge, speedy action is called for on the part of the banker and timely and firm handling are of essence. In such cases, the banker may intervene even in management, if that is necessary, in the interest of all concerned and the public. To diagnose the ailment, the banker can go to a consultant and can then arrange for action, including a financial or structural reorganisation (Paragraphs 12.13 to 12.17).

67. The Indian Banks' Association has an important role to play in a study of the environment and particularly the impact of regulations and enactments on the working of banks (Paragraph 12.18).

68. Expertise has to be built up in the banking system in organising industry-wise studies, on an on-going basis, which should serve as a frame of reference for decision-making in regard to individual cases (Paragraph 12.19).

69. Instead of every bank attempting to make detailed studies of all the major industries it would be beneficial if some selected banks concentrate on one or two industries each, for which they may be best fitted to study; the results of their study could be made available to the other banks as also the Reserve Bank (Paragraph 12.20).

70. It is opportune to examine whether the limits for the credit authorisation requirements of the Reserve Bank should not be raised, in view of the altered value of the rupee since the introduction of the Credit Authorisation Scheme and the qualitative improvement in the lending skills of commercial banks. (Paragraph 12.22).

71. Inventory receivables norms should be given effect to immediately, while action should be initiated to implement the new approach to lending within the time-bound schedule as proposed in Chapter 6 (Paragraph 13.2).

72. Steps should be taken simultaneously to introduce the suggested informatiion system for all industrial borrowers with limits aggregating Rs. 1 crore and above from the banking system and the process completed within six months (Paragraph 13.3).

73. Banks should utilise this transitory period of six months for conducting training sessions for their operating officials (Paragraph 13.3).

74. Special courses should be organised by the National Institute of Bank Management and the Bankers Training College for training the banks' operating officials. These institutions may also help banks in training the trainers, preparing operational manuals, and in bringing about changes in their systems and procedures (Paragraph 13.4).

75. Each bank should conduct banker-borrower seminars to create an understanding between the operating officials in the respective banks and their customers (Paragraphs 13.5).

76. After six months, a bankers' seminar may be convened in the Bankers Training College where operating officials can find solutions to any operational problems that might have been thrown up in the interim (Paragraph 13.5).

77. The prime contribution of the Committee of Direction appointed by the Reserve Bank will be to take forward the work of the Study Group to a continuing function of a dialogue with industry and banks to ensure smooth running of the new system and to take care of the need for any revision (Paragraph 13.6).

REPORT OF THE WORKING GROUP TO REVIEW THE SYSTEM OF CASH CREDIT - RBI (1979)

(Chairman : Shri K. B. Chore)

SUMMARY OF RECOMMENDATIONS

1. The advantages of the existing system of extending credit by a combination of the three types of lending, viz., cash credit, loan and bill should be retained. At the same time it is necessary to give some directional changes to ensure that wherever possible the use of cash credit would be supplanted by loans and bills. It would also be necessary to introduce necessary corrective measures to remove the impediments in the use of bill system of finance and also to remove the drawbacks observed in the cash credit system (Paragraph 4.22).

2. Bifurcation of cash credit limit into a demand loan portion and a fluctuating cash credit component has not found acceptance either on the part of the banks or the borrowers. Such bifurcation may not serve the purpose of better credit planning by narrowing the gap between sanctioned limits and the extent of utilisation thereof. It is not likely to be voluntarily accepted and it does not confer enough advantages to make it compulsory (Paragraphs 5.2 and 5.4).

3. The need for reducing the over-dependence of the medium and large borrowers - both in private and public sectors - on bank finance for their production trading purposes is recognised. The net surplus cash generation of an established industrial unit should be utilised partly at least for reducing borrowing for working capital purposes (Paragraph 5.7).

4. In order to ensure that the borrowers do enhance their contributions to working capital and to improve their current ratio, it is necessary to place them under the Second Method of lending recommended by the Tandon Committee which would give a minimum current ratio of 1.33:1. As many of the borrowers may not be immediately in a position to work under the Second Method of lending, the excess borrowings should be segregated and treated as a working capital term loan which should be made repayable in instalments. To induce the borrowers to repay this loan, it should be charged a higher rate of interest. For the present, the Group recommends that the additional interest may be fixed at 2 per cent per annum over the rate applicable on the relative cash credit limits. This procedure should be made compulsory for all borrowers (except sick units) having aggregate working capital limits of Rs. 10 lakhs and over (Paragraph 5.9).

5. While assessing the credit requirements, the bank should appraise and fix separate limits for the 'normal non-peak level' as also for the 'peak level' credit requirements indicating also the periods during which the separate limits would be utilised by the borrower. This procedure would be extended to all borrowers having working capital limits of Rs. 10 lakhs and above. One of the important criteria for deciding such limits should be the borrowers' utilisation of credit limits in the past (Paragraphs 5.10 to 5.12).

6. If any *ad hoc* or temporary accommodation is required in excess of the sanctioned limit to meet unforeseen contingencies the additional finance should be given, where necessary, through a separate demand loan account or a separate 'non-operable' cash credit account. There should be a stiff penalty for such demand loan or 'non-operable' cash credit portion, at least two per cent above the normal rate, unless Reserve Bank exempts such penalty. This discipline may be made applicable in cases involving working capital limits of Rs. 10 lakhs and above (Paragraphs 5.13 and 5.14).

7. The borrower should be asked to give his quarterly requirement of funds before the commencement of the quarter on the basis of his budget, the actual requirement being within the sanctioned limit for the particular peak level/non-peak level periods. Drawings less than

or in excess of the operative limit so fixed (with a tolerance of 10 per cent either way) but not exceeding sanctioned limit would be subject to a penalty to be fixed by the Reserve Bank from time to time. For the time being, the penalty may be fixed at 2 per cent per annum. The borrower would be required to submit his budgeted requirements in triplicate and a copy each would be sent immediately by the branch to the controlling office and Head Office for record. The penalty would be applicable only in respect of parties enjoying credit limits of Rs. 10 lakhs and above, subject to certain exemptions (Paragraphs 5.15 to 5.20).

8. The non-submission of the returns in time is partly due to certain features in the form themselves. To get over this difficulty, simplified forms have been proposed. As the quarterly information system is part and parcel of the revised style of lending under the cash credit system, if the borrower does not submit the return within the prescribed time, he should be penalised by charging the whole outstandings in the account at a penal rate of interest, one per cent per annum more than the contracted rate for the advance from the due date of the return till the date of its actual submission (Paragraph 5.21).

9. Requests for relaxation of inventory norms and for *ad hoc* increases in limits should be subjected by banks to close scrutiny and agreed to only in exceptional circumstances (Paragraph 5.22).

10. The banks should devise their own check lists in the light of the instructions issued by the Reserve Bank for the scrutiny of data at the operational level (Paragraph 5.23).

11. Delays on the part of banks in sanctioning credit limits could be reduced in cases where the borrowers co-operate in giving the necessary information about their past performance and future projections in time (Paragraph 5.24).

12. As one of the reasons for the slow growth of the bill system is the stamp duty on usance bills and difficulty in obtaining the required denominations of stamps, these questions may have to be taken up with the State Governments (Paragraph 5.25).

13. Banks should review the system of financing book debts through cash credit and insist on the conversion of such credit limits into bill limits (Paragraph 5.26).

14. A stage has come to enforce the use of drawee bills in the lending system by making it compulsory for banks to extend at least 50 per cent of the cash credit limit against raw materials to manufacturing units whether in the public or private sector by way of drawee bills. To start with, this discipline should be confined to borrowers having aggregate working capital limits of Rs. 50 lakhs and above from the banking system (Paragraphs 5.27 and 5.29).

15. Banks should insist on the public sector undertakings/large borrowers to maintain control accounts in their books to give precise data regarding their dues to the small units and furnish such data in their quarterly information system. This would enable the banks to take suitable measures for ensuring payment of the dues to small units by a definite period by stipulating, if necessary, that a portion of limits for bills acceptance (drawee bills) should be utilised only for drawee bills of small scale units (Paragraph 5.30).

16. To encourage the bill system of financing and to facilitate call money operations an autonomous financial institution on the lines of the Discount Houses in U.K. may be set up (Paragraphs 6.1 to 6.11).

17. No conclusive data are available to establish the degree of correlation between production and quantum of credit at the industry level. As this issue is obviously of great concern to the monetary authorities the Reserve Bank may undertake a detailed scientific study in this regard (Paragraph 7.2).

18. Credit control measures to be effective will have to be immediately communicated to the operational level and followed up. There should be a 'Cell' attached to the Chairman's office at the Central Office of each bank to attend to such matters. The Central Offices of banks

should take a second look at the credit budget as soon as changes in credit policy are announced by the Reserve Bank and revise their plan of action in the light of the new policy and communicate the corrective measures to the operational levels as quickly as possible (Paragraph 7.3).

19. Banks should give particular attention to monitor the key branches and critical accounts (Paragraph 7.4).

20. The communication channels and systems and procedures within the banking system should be toned up so as to ensure that minimum time is taken for collection of instruments (Paragraph 7.5).

21. Although banks usually object to their borrowers dealing with other banks without their consent, some of the borrowers still maintain current accounts and arrange bill facilities with other banks, which vitiate the credit discipline. Reserve Bank may issue suitable instructions in this behalf (Paragraph 7.6).

REPORT OF THE WORKING GROUP ON THE ROLE OF BANKS IN IMPLEMENTATION OF NEW 20-POINT PROGRAMME - RBI (1982)

(Chairman : Shri A. Ghosh)

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

1. Of the 20 points in the New Programme, 12 points have direct relevance to the banking system. The implications of these points from the point of view of bank assistance, the type of assistance that may be rendered by banks and the beneficiaries requiring assistance have been indicated in paragraphs 2.4 to 2.15. A statement listing the various items of the 20-Point Programme, nature of bank assistance and persons or organisations who would be benefited under each item has been appended to the report (Annexure III). The State Governments, in close collaboration with banks and/or ARDC/NABARD, should draw up specific schemes/ plans of action under the various points in a co-ordinated manner, taking into account the various development programmes in the States, so that a clear picture of the bank assistance to be provided emerges and suitable tie-up arrangements are made. (Para 2.4 to 2.16)

2. The inter-Disciplinary Group set up by RBI in connection with bank assistance to decentralised sector may be activated. (Para 2.15)

3. While no change is considered necessary in the overall composition of priority sector, modifications are proposed in the definitions of some components of the priority sector, with a view to ensuring that the thrust is towards financing the smaller borrowers. The modifications suggested are: (i) advances for acquisition of only one tractor under agriculture, (ii) advances for purchasing only one vehicle under road and water transport operators, (iii) besides fair price shops dealing in essential commodities and consumers' co-operative stores, any other retail traders with credit limits not exceeding Rs. 25,000/- under retail trade, (iv) small business with working capital limits not exceeding Rs. 1 lakh, and (v) professionals and self-employed persons with credit limits not exceeding Rs. 1 lakh. (Paras 3.2 and 3.3)

4. The net funds made available to RRBs by sponsor banks may be treated as priority sector advances of sponsor banks. This should ensure that sponsor banks evince greater interest and enable RRBs to play a greater role in financing priority sector and 20-Point beneficiaries. (Para 3.4)

5. There is no need to alter the overall target of 40% of total bank credit, set for priority sector advances. (Para 4.2)

6. A target of 14% of total bank credit has been suggested for direct finance to agriculture and allied activities against the present target of 16% for both direct and indirect finance to agriculture and allied activities. (Para 4.3)

7. Banks should take steps to increase the share of advances for minor irrigation and land development purposes substantially. (Para 4.3)

8. The definition of weaker sections in priority sector should correspond to the beneficiaries under the 20-Point Programme which is aimed at improving the living standard of the weakest sections of the society. Accordingly, it is proposed that the weaker sections in priority sector may comprise (i) small and marginal farmers as defined now, landless labourers, tenant farmers and sharecroppers, (ii) artisans, village and cottage industries, (iii) IRDP beneficiaries, (iv) Scheduled Castes/Scheduled Tribes, and (v) DRI beneficiaries. Net funds made available by sponsor banks to RRBs may also be treated under this category as advances by RRBs are given almost entirely to beneficiaries identified as weaker sections. (Para 4.6)

9. The advances to the weaker sections as identified above should reach a level of 25% of priority sector advances or 10% of total bank credit by the end of March 1985. (Para 4.6)

10. Sustained efforts are called for on the part of the banking system to achieve the estimated increase in the level of outstanding credit to weaker sections. The field level machinery has to be geared up to achieve this task. The systems and procedures have to be suitably simplified keeping in view the type of beneficiaries to be financed and the same should be implemented effectively at the field level. (Para 4.6)

11. The State Government and their agencies have a variety of responsibilities like systematic identification of schemes and beneficiaries, provision of extension services, linkages and infrastructural facilities, provision of necessary inputs and assistance in marketing end products, technical support in preparation and implementation of schemes, monitoring and ensuring at ground level proper implementation of schemes, conducting techno-economic studies, assisting the timely recovery of loans and arrangements for imparting training to beneficiaries. The achievement of the targets for assisting the weaker sections would depend critically upon the co-ordinated and effective perfromance of their respective roles by banks as well as Governmental agencies (Para 4.6, 4.7 and 6.4)

12. There is no scope for raising the target of 1% prescribed for DRI advances. There is, however, need for more precise means of identifying the beneficiaries under the DRI Scheme. The Government and Reserve Bank may consider this on the basis of the findings of the study carried out by NIBM. (Para 4.8)

13. It is not considered necessary to make any change in the existing target for credit-deposit ratio of rural and semi-urban branches. The credit.-deposit ratio on an area-wise basis is not a perfect guide to measure the performance of banks. (Para 4.9)

14. It may not be feasible to achieve the target of 40% set for priority sector advances uniformly in all states. It will not also be practicable to fix different targets on a State-wise basis. (Para 4.10)

15. The co-operative and RRBs have an important role to play in the implementation of the New 20-Point Programme. In this context, there is need for effective co-ordination between commercial banks, RRBs, and co-operatives in implementing DCPs. (Para 5.1)

16. For ensuring effective participation of the co-operatives, it is necessary to take certain steps such as (i) implementing a time-bound programme for re-organisation and revitalisation of weak co-operative banks, primary agricultural societies and industrial societies (ii) provision of adequate trained personnel (iii) setting up of separate moniotring cells in the co-operative Departments and District Co-operative Banks to review the performance of co-operatives in the matter of implementation of the 20-Point Programme etc. (Para 5.3)

17. Weakening of financial institutions, prticularly co-operatives, as a result of accumulation of overdues and consequent non-recycling of funds should be considered as a matter of concern not only to the financial institutions but also to State Governments and developmental agencies concerned. Concerted efforts should, therefore, be made all round to promote a healthy recovery atmosphere and ethics. (Para 5.3)

18. Co-operative banks may ensure that the share of the weaker sections is not less than half of the total credit advanced by co-operatives during a year. (Para 5.4)

19. RRBs should draw up plans to ensure sizeable participation by them in financing the 20-Point Programme. (Para 5.5)

20. There has to be a proper phasing of the programmes and schemes under each of the points and also fixation of priorities by the State Governments Schemes which will provide immediate benefits and for which necessary linkages are readily available may be taken up initially. (Para 6.2)

21. Banks should integrate assistance to 20-Point beneficiaries under DCPs/AAPs by including all viable/bankable schemes drawn up under the Programme. (Para 6.3)

22. The guidelines issued by RBI for making the DCC an effective instrument of co-ordination need to be implemented by banks and State Governments. Similarly, the SLCC should be made an effective instrument of co-ordination at the State level. (Para 6.5)

23. The question of setting up suitable intermediary organisations, with appropriate back-up facilities, may be considered by State Governments to facilitate credit flows in an organised manner to the weaker sections as well as assistance regarding input supply and Marketing. (Para 6.8)

24. The question of training of Government officials, particularly at the District/block level in preparation and implementation of bankable scheme, etc. needs to be pursued. Adequate arrangements should be made for on-going training of Government and bank officials so as to bring about required orientation in them for purposeful extension of institutional credit support to the beneficiaries of the 20-Point Programme and other weaker sections. Banks may review the training facilities for staff posted to rural and semi-urban branches and take steps to augment them to the required level. (Para 6.6 and 6.7)

25. The recommendations made by CRAFICARD for making commerical banks an effective instrument in lending in rural areas, more particularly relating to staffing pattern with adequate technical support and attitudinal changes in the staff of the rural branches should be implemented on an urgent basis. The process of recruitment through Regional Recruitment Board needs to be expedited. (Para 6.7)

26. The weaker section beneficiaries need to be organised into homogenous functional groups, preferably in the form of co-operatives or registered societies with support from developmental agencies at the district/State level in matters like technical advice, input supply and marketing. (Para 6.9)

27. A quarterly return of advances under each of point of the 20-Point Programme, with State-wise data, may be obtained. The Schedules now prescribed under the NIS for reporting assistance to 20-Point beneficiaries may be dispensed with. The quetion of simplifying the NIS may also be considered. (Para 7.2)

28. There is an urgent necessity to machanise data processing and consolidation in banks. The RBI and Government may consider this, taking into account the recommendations of the Working Group on Accounting System at Bank Branches. (Para 7.3)

29. Effective action should be taken to institute a regular mechanism for monitoring the progress of priority sector lending including assistance under the 20-Point Programme by each bank through budgeting, returns, review, on the spot study, reporting to Board, etc. State-wise/District-wise review of the performance may be made through the DCCs and SLCCs. The performance of the banking system including the RRBs and the co-operatives, may be continuously monitored by the RBI. Apart from evaluation studies by banks, arrangements for having a permanent machinery at State level for undertaking such studies, area-specific, activity specific or organisation specific, as appropriate may be considered. RBI may consider publishing a review of all such studies annually. (Para 7.4)

REPORT OF THE COMMITTEE TO REVIEW THE WORKING OF THE CREDIT AUTHORISATION SCHEME - RBI (1983)
(Chairman : Shri S. S. Marathe)

SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

1. CAS is not to be looked upon as a mere regulatory measure confined to large borrowers. Its basic purpose is to ensure orderly credit management and to improve quality of bank lending so that all borrowings, whether large or small, are in conformity with the policies and priorities laid down by the Central Banking Authority. The continued surveillance by RBI over the lending operations of banks through CAS has still an important role to play (Paragraphs 4.2 and 4.6).

2. It would be desirable to evolve a system in which there is an incentive for the borrowers to comply with all the requirements of the Scheme and for the banks to improve the quality of credit appraisal. This can be best achieved by ensuring that all cases where such compliance exists, receive preferential treatment in the form of not requiring prior authorisation of RBI (Paragraph 4.7).

3. The banks should be allowed discretion to deploy credit in CAS cases which fulfil the following requirements, without RBI's prior authorisation :

i)Reasonableness of estimates/projections in regard to sales, chargeable current assets, other current assets, current liabilities (other than bank borrowings) and net working capital, (ii) classification of current assets and current liabilities in conformity with the guidelines issued by the Reserve Bank, (iii) maintenance of minimum current ratio of 1.33:1 (except under exempted categories), (iv) prompt submission of quarterly operating statements by the borrower, for the past 6 months with an undertaking to do so in future also, and (v) an undertaking by the borrower to submit his annual accounts promptly and regular annual review being carried out by the bank even where enhancement in credit facility is not involved (Paragraph 5.3).

4. The deployment of credit by a bank under its discretion, should be subject to its furnishing a certificate to RBI signed by a senior executive (duly authorised in this respect by its Board) to the effect that he had satisfied himself about the proposal conforming to all the requirements stated under 3 above (Paragraph 5.4).

5. The proposals referred to in 4 above would go through normal process of scrutiny in RBI and if as a result of it, it was found that the credit limit sanctioned was not warranted or was excessive, corrective action would be taken by the bank as directed by RBI (Paragraph 5.4).

6. In respect of export-oriented manufacturing units which export not less than 75% of the turnover of the goods manufactured by them, the credit proposals should be disposed of at banks' level, without prior reference to RBI, provided the banks are satisfied about the reasonableness of the exporters' credit needs and subject to condition similar to that indicated under 5 above (Paragraph 5.5).

7. The other CAS proposals not satisfying the suggested parameters should continue to undergo pre-disbursement scrutiny at RBI as at present. Such a scrutiny should recognise the respective roles of RBI and banks in regard to the type of scrutiny each should undertake in order to ensure expeditious disposal of the applications (Paragraph 5.6).

8. Exemptions from prior authorisation and enlarging discretionary powers of banks in respect of certain specific credit facilities should remain an on-going exercise (Paragraph 5.7).

9. For borrowers having working capital limits in excess of Rs. 5 crores, banks could allow ad hoc limits for periods up to 3 months to the extent of 25% of their additional limit sought for

without any ceiling, provided they are found need based by banks (Paragraph 5.7).

10. Some of the present exemptions from prior authorisation may be reviewed by the Reserve Bank as they appeared to be contrary to the concept of permissible bank finance computed on the basis of minimum contribution by borrowers towards net working capital (Paragraph 5.8).

11. In keeping with the spirit of the policy of placing increasing degree of reliance on judgement of banks, the L/C facilities for acquisition of current assets as well as capital equipment, should be exempted from the requirement of prior authorisation (Paragraph 5.10).

12. The Committee of Direction (COD) should take up immediately the task of reviewing the existing inventory and receivables norms, prescribing norms for more industries and further disaggregation of industry groups to the extent necessary. COD may constitute appropriate number of industry-wise sub-committees for this work. The review of norms should be repeated at reasonable intervals (Paragraph 5.11).

13. COD may examine certain suggestions made by the Institute of Chartered Accountants of India about modifications in CAS forms and recommend changes in them wherever they find them desirable and feasible (Paragraph 5.12).

14. RBI should, wherever available, obtain clarifications, etc. on CAS proposals under its scrutiny from the concerned Zonal/Regional Office/branch office of the applicant bank, with copies of correspondence endorsed to the bank's Head Office (Paragraph 5.14).

15. Steps should be taken by RBI to ensure prompt submission of data by banks in Forms A & B so as to make it an effective instrument of monitoring their advances portfolios (Paragraph 5.15).

16. RBI should prepare a booklet on CAS and revise and update it periodically. It should be made available as a priced publication (Paragraph 5.16).

17. The suggestions made by the IDBI in its memorandum to the Committee regarding modifications in RBI's approach to term lending by commercial banks should be taken up directly by RBI with IDBI and suitable changes in approach and procedures wherever desirable and feasible, be made as a result of mutual discussions (Paragraph 6.5).

18. The factors on account of which restrictions on term loans by banks were introduced and have been continued all these years, still remain valid and perhaps more so, as is evidenced by rising share of term loans in the portfolios of banks. The restrictions on term loans by banks should, therefore, continue (Paragraph 6.5).

19. There is a need for having a fresh look at the norms laid down by the Bhuchar Committee in 1978. The standing Co-ordination Committee which was set up in terms of the recommendations of that Committee should effectively function as a focal point of co-ordination on an on-going basis between RBI, commercial banks and term lending institutions (Paragraph 6.5).

20. In the interest of quality and speed of disposals, CAS advances in banks should be concentrated, to the extent possible, at selected number of specialised branches in metropolitan centres equipped with necessary expertise and staff strength (Paragraph 7.5).

21. The committee approach should be adopted for rationalising the number of levels at each tier in a bank, wherein appraising/initiating officer can circulate a background note for discussion amongst different concerned levels and a joint view could be taken (Paragraph 7.6).

22. Credit proposals put up to the banks' Boards, etc. should invariably contain definite views on various requirements of lending discipline prescribed in paragraph 5.3. This will help in uniform treatment of the proposals in judging their compliance with the lending disci-

pline and also categorise the proposal as being eligible to pass through 'fast track' or otherwise (Paragraph 7.8).

23. While it is desirable to have a mix of professionals (Chartered Accountants, engineers and financial analysts) in credit appraisal departments of commercial banks at different tiers and levels, increasing emphasis should be on job training and personal competence (Paragraph 7.9).

24. Steps should be taken by RBI to reorganise IECD so as to cut down delays. This may be done by redistribution of work load among various industry groups, prompt action on proposals requiring clarifications, streamlining procedures in regard to preparation of notes on credit proposals so as to focus attention on only the important issues, augmenting the strength of the staff to eliminate the 'lag' time in taking up the proposals for scrutiny, and improving infrastructure facilities for quick contacts with banks and for transmittal of decisions (Paragraph 7.11).

25. The work in IECD for handling CAS proposals is of a technical nature and requires fair degree of skill in credit appraisal. The authorities in RBI should give due weightage to this aspect (Paragraph 7.12).

26. On account of various factors which have a bearing on time involved in disposal of credit proposals in commercial banks and RBI, the Committee feels that a specific time prescription may be arbitrary. A system should however be established by which all pending cases are reported to an appropriate senior level once a month if the tendency is in excess of 120 days in the case of commercial banks and 30 days in the case of Reserve Bank (Paragraph 7.13).

27. The data being collected from banks in Forms A and B contains great deal of important and relevant information. This needs to be properly analysed, tabulated and computrised so as to develop an effective data base which would be valuable in many ways. All efforts should be made to improve radically the extremely unsatisfactory position in regard to submission of the forms in time, free of inconsistencies and incentives should be provided to those who comply with the requirements of the information system. The periodicity of Form A could be reduced from monthly to quarterly but then it should be made incumbent on the banks to send them regularly and without excessive time lag (Paragraphs 8.5, 8.6 and 8.7).

28. With the installation of the proposed computer facility in RBI, the data base could be made more comprehensive by feeding into it information pertaining to term finance available from term lending institutions (Paragraph 8.6).

29. A mechanism should be evolved by RBI by which an aggrieved borrower (enjoying credit facilities over Rs. 50 lakhs) should have the opportunity to get redress in appropriate cases, wherein he desires transfer of his borrowal account from one bank to another (Paragraph 8.8).

30. The present CAS may be redesignated as "Credit Monitoring Scheme" so as to reflect the important change in broad approach and emphasis (Paragraph 8.9).