

Deficit Financing and the Environment for Monetary Policy

Deficit financing, defined narrowly as the change in the government's indebtedness to the Reserve Bank of India, has been an important part of plan financing in India, and a key element in determining the environment for monetary policy. This generalization is also largely true for the three five-year plans spanning the years covered by this volume. Of the total public sector outlay (actual) of Rs 1,960 crores in the first plan (1951-56), Rs 260 crores (or 13.26 per cent) were accounted for by the Bank's lending to the government. Lulled by low rates of inflation during the first plan and the availability of large sterling balances, the planning authorities took recourse to deficit financing for a quarter of the investment effort in the second plan (1956-61). Thus Rs 1,170 crores of the actual public sector outlay of Rs 4,672 crores represented the change in the government's indebtedness to the Bank. The lessons of the second plan were not entirely lost on the country's planners. But neither were they fully learnt, and the corresponding figures for the third plan (1961-66) were Rs 1,133 crores and Rs 8,577 crores respectively, the former representing a more modest 13.2 per cent of the latter. Borrowings from the Bank accounted for Rs 676 crores (or 10.2 per cent) of the actual public sector outlay of Rs 6,628 crores during the three annual plans (1966-69) which preceded the resumption of quinquennial planning in 1969.

The impact of these levels of deficit financing on the key monetary policy variables of a closed economy, viz. money supply and the rate of inflation, was quite pronounced. During the first plan, money supply rose by only about 10 per cent or a compound rate of growth of under 2 per cent per annum, while wholesale prices (1952-53=100), largely reflecting external developments in the aftermath of the Korean boom and a succession of good harvests at home, actually fell by over 17 per cent in this period. Inflationary pressures were however unrelenting during the next two plans, wholesale prices rising nearly 35 per cent alongside a rise in money supply of about 32 per cent

during the second plan. Wholesale prices rose some 37 per cent during the third plan, while money supply, aided by rapid expansion of commercial bank credit, increased by over half.¹

DEFICIT FINANCING AND THE BANK

In the early years of planning, there was consensus among India's policy-makers about the need for deficit financing as a means of plugging the gap between ambitious investment plans and the low levels of savings in an underdeveloped economy. Indian planners were not unaware of the dangers of the inflation which might result. But with large foreign exchange reserves, they were confident of the government's ability to manage the supply-side of the economy. This consensus was also largely echoed by the International Monetary Fund mission headed by Edward Bernstein which came to India in 1953 at the invitation of the government.

For much of the 1950s, the Bank was part of this consensus. Although the impact of deficit financing on prices had aroused concern already in 1951-52, price stability did not return as a major cause of worry at the Bank until the mid-fifties. Besides, the Bank recognized the need for any plan to go beyond what available resources dictated, even if some part of the additional investment had to be financed through additions to money supply. Ironically despite the first plan document highlighting the important role of the central bank, the Reserve Bank also took a rather modest and self-effacing view about its own part in the planning process during these years, insisting that while it was entitled to be consulted by the government regarding the dimensions of the plan effort, the final decisions rested with the latter. The monetary policy authorities were, consequently, content to 'function within the limitations created by the effort to carry out the plans'.

The Reserve Bank of India was not given sufficient time to consider the first five-year plan, the plan document arriving in Bombay only towards the close of October 1952. Any contribution the Bank made to the first plan document appears to have been cosmetic, rather than substantial, with the Governor, B. Rama Rau, for instance, choosing merely to object to the plan document's suggestion that 'real democracy' implied the 'equality of incomes'. While the intervening years may have revealed the Bank's earlier fears about

¹ In keeping with the definition in vogue at the time, 'money supply' in this volume refers to 'narrow money' (M1), comprising currency in circulation and demand deposits.

inflation to be exaggerated, concern about prices resurfaced towards the end of 1955, though more in the context of the second plan's priorities than its financing proposals. Commenting on the former, Rama Rau cautioned the Finance Ministry that the public investment envisaged in the plan would lead to excess demand for consumer goods, and to 'serious inflationary pressures'. Though not seemingly within the Bank's remit, Rama Rau added, it was his duty to bring these dangers to the government's attention since the Bank was 'partly, if not mainly, responsible for applying appropriate remedies to curb inflation'.

The Bank's Central Board of Directors was given an opportunity to reflect on the draft documents of the second plan in January 1956. Several members of the Board were apprehensive that the financing requirements of so large an investment programme with a planned public sector outlay of Rs 4,800 crores would involve substantial recourse to the Bank and generate inflationary pressures. Similar views had been voiced earlier during the Economists' Panel's rather cursory discussions of the second plan, among others by D.R. Gadgil, a Director of the Central Board and B.K. Madan, Economic Adviser at the Bank. The Bank's *Annual Report* for 1955-56 emphasized the need for financial stability promoted by a 'judicious mix' of monetary and fiscal policies and warned against taking too sanguine a view based on recent experience, of the pressure that the stepped up plan effort and the manner of financing it was likely to exert on prices. This already marked a departure from the more hopeful view the publication had taken a year earlier. But the Bank also persisted in its belief that no government sensitive to the welfare of the people and, one may add, having at regular intervals to renew its popular mandate, would go very far down the path of inflation. Hence the view prevailed that 'calculated risks' in regard to inflation were justified and that development plans should not be sacrificed to allay fears on the price front unless stabilization were to prove impossible.

There were several reasons why the Bank's overall attitude towards deficit financing during this period was nuanced and pragmatic, rather than doctrinaire. Some of these emerged clearly in the course of the visit to Bombay in February 1958 of Per Jacobsson, the Managing Director of the IMF. The latter's discussions at the Bank revealed that while not altogether unsympathetic towards India's development problems and efforts, he was sceptical about the policy of deficit financing and doubtful that it would give the government any substantial command over additional real resources for investment. Coming at the end of nearly two stressful years of the second plan, Per Jacobsson's plea for monetary stability would

THE BRIDGE THAT T.T. BUILT



- Tol. 5 Dec. 1956

not have failed to strike a responsive chord in Bombay. But placed as it so often was in the position of a credible protagonist of the government's views to the Fund and an interpreter of those of its interlocutors to the authorities in New Delhi, the Bank used three arguments to explain to the visitor why the level of deficit financing envisaged in the second plan was unlikely to affect prices as severely as feared, or unduly expand money supply.

The second plan provided for net reserve losses of Rs 200 crores over five years to finance part of a payments deficit 'planned' with the object of transferring real resources to India from the rest of the world. (The remainder was expected to be covered by capital inflows and external assistance.)² Hence, the Bank's credit to the government sector would not translate directly into an increase in money supply but would be moderated by changes in the country's foreign exchange reserves. Secondly, the process of monetization which was

² Reserve losses during the first year of the second plan were larger than plan estimates for the entire five-year period. But the Bank and the government continued at this time to maintain, in public, the validity of the second plan's assumptions.

continuously under way in the economy could be expected to accelerate as a result of the development effort and lead to changes in the income velocity of money.³ Finally, there was the prospect of rising incomes and standards of living. Both these factors were likely, in the first instance, to increase the public's demand for cash balances. Declining reserves and rising cash balances with the public could, the Bank argued, be expected greatly to moderate the inflationary potential of the government's budgetary outlays during the second plan.

In judging the effects of deficit financing on the economy, the Bank was also disposed to consider a number of other factors some of which in turn, helped determine the range of monetary policy instruments deployed to stabilize prices. For example it regarded the availability of wage goods, chiefly foodgrains, as a major influence upon the extent to which any given level of deficit financing or public investment affected domestic prices. Generally speaking, the Bank also expected the relatively small role played by bank money in overall money supply and the substantial leakages of currency from the banking system to mitigate the inflationary impact of the expansion of its credit to the government. Briefly in the mid-fifties, the Bank apprehended rapid deposit growth weakening its control over the commercial banks' credit mechanism, and armed itself with powers to regulate it. These powers were even used twice in 1960. But throughout these years, currency formed about two-thirds or more of money supply and the Bank's judgement was, on the whole, that the potential for multiple credit creation was realistically still quite limited for any given level of base money.

The Bank's efforts to persuade Per Jacobsson that deficit financing in India was not beyond the limits of prudence were not entirely unavailing. Though his 'basic ideas' did not change very much, Per Jacobsson appears to have recognized that his early reactions were based on 'first hurried impressions' and that the issue showed itself, on closer examination, to be 'not quite so simple'. But within the Bank itself, a sense of unease had long been palpable. As the volume of deficit financing grew during 1956-58 and the price and external payments environments deteriorated, the Bank grew progressively more vocal in expressing its views that deficit financing should be kept within manageable limits, and that plan exercises should bear a closer

³ Readers may note that as used in these chapters, the term 'monetization' lends itself to two meanings. Firstly, it refers, as in this instance, to the process by which the so-called non-monetized sector is brought into the 'monetized' sector of the economy. Elsewhere in these pages, the term is also used in the more contemporary sense, to represent the monetary effects of deficit financing.

relation to the availability of real investible resources in the economy and to the ability of the government to mobilize them.

TOWARDS A MORE CAUTIOUS APPROACH

The turning point, to the extent that it is possible to identify one, probably came as early as August 1956. Although the external payments position had turned markedly adverse in recent months, there was no sense yet of a crisis. Indeed the bill to amend the currency cover which was then at an advanced stage assumed that the country's foreign exchange reserves would normally not fall below Rs 500 crores. This assumption would soon be belied, but few contemplated the possibility in July 1956. As discussed at somewhat greater length below, the Deputy Governor, K.G. Ambegaokar, spent several days in August arguing the case for *increasing* the government's issue of ad hoc treasury bills (or ad hocs), his object being to tide the Issue Department over its problem of finding eligible assets to back the additions to currency necessitated by the growth of commercial bank credit. Towards the end of August, a letter from Rama Rau to the Prime Minister, Jawaharlal Nehru, mentioned the possibility of the second plan outlay having to be reduced in the event of the price and foreign exchange positions getting out of hand, and monetary policy instruments being found wanting. But such scenarios were still regarded as hypothetical.

Accompanied as it was by considerable debate within the organization, the change which came over the Bank's outlook after August 1956 was not as sudden as it might seem. Some of the arguments in this debate percolated to the outside world in the form of hypothetical formulations about alternative resource scenarios, about the monetary impact of the deficit financing exercise, and so on. But from autumn 1956, the Bank began raising the tone of its cautionary remarks about inflation. Senior Bank officials even began to voice their concern about the price situation in public, and to think aloud about the distortions in the flow of resources which inflation might cause. This concern deepened as the real dimensions of the exchange problem dawned on the Bank's officials and it became clear that apart from domestic savings, the availability of foreign aid was critical to achieving the second plan's investment targets. A detailed discussion of the Bank's monetary and credit policies is reserved for the chapters which follow. We may merely note here that although the Bank was committed to a policy of 'controlled expansion' which satisfied the demand for productive credit without the resulting monetary growth outpacing the community's capacity to mobilize real resources, its stance during the 1956-57 busy season tended against its own better judgement to emphasize expansion at the cost of control. With monetary policy following

the expansionary course set by fiscal policy, prices—particularly of food articles and agricultural raw materials—continued to rise, leaving the Bank with little choice but to impose selective controls. Although it was sensitive to the limitations of general instruments of credit control and alive to the advantages of selective controls, overall policy during the 1956–57 peak season (discussed in chapter 3) was too liberal for the Bank’s liking.

The developments during the 1956–57 busy season, including differences with the Finance Minister over the thrust of policy, held several lessons for the Reserve Bank. Even generally inflation-averse governments, officials at Mint Road now realized, might easily overestimate the limits of prudent deficit financing and that, once under way, the latter triggered an inflationary dynamic which was not easy to check or reverse by means of monetary policy alone. Hence in the long run, there was no serious alternative to financing investment except through increasing savings or otherwise mobilizing real resources. Since the real resource effort appeared to have reached a plateau and there were limits to the extent to which it could be stepped up in the near future, by the summer of 1957 the Bank began more openly to consider the option of reducing the size of the second plan. The meetings which the new Governor, H.V.R. Iengar, held with state finance ministers during these weeks brought home to him the difficulties they faced in getting resources for the plan. While ‘afraid to speak ... their minds’ in public, he informed the Union Finance Minister, T.T. Krishnamachari, in July 1957, they were willing in private conversations to talk frankly about the need to ‘cut the Plan down to available resources’. Many ministers thought such a step unavoidable, and felt it was a ‘serious mistake’ for the central government to maintain that the plan would not be scaled down on any account since doing so merely raised the political and other costs of the eventual climb-down. Iengar was quite outspoken to Krishnamachari about his own preference:

I realize ... the Government of India are in an exceedingly difficult position; for any Government to have to say ... that they are defeated is politically and otherwise a difficult ... thing to do; but the question seems one of emphasis and mode of presentation.

Although there was little it could do other than warn, the Bank had grown by now to be watchful for signs of fiscal laxity. The Bank’s net credit to the government peaked in 1957–58 at Rs 421 crores, dropping the following year to Rs 156 crores. But the 1959–60 budget proposed a deficit financing component of Rs 245 crores, provoking Iengar to protest to the Finance Minister, Morarji Desai, that apart from being in excess of anything ‘conceived to be probable’ earlier, the planned deficit made the price level hostage to the

prospects of a 'really first class' monsoon. In the event, the actual deficit at the end of 1959-60 was lower by about Rs 100 crores than planned. The 1960-61 budget in turn allowed for a deficit of Rs 250 crores. Alerting the Finance Minister that the resulting inflation would 'seriously embarrass' the government and set the third plan off to a rocky start, the Governor declared that monetary policy being limited in scope, its effectiveness would be 'immeasurably enhanced if fiscal policy worked in the same direction rather than against the current of monetary measures instituted by the Bank'. Moreover, severe restrictions on bank credit while 'deficit financing continued apace' were likely to distort 'the price and cost structure' and 'dampen ... productive enterprise'. The Governor also urged the minister to undertake an immediate review of the 'internal resources and expenditure position' in the concluding year of the second plan so that the actual extent of deficit financing during the plan did not exceed the original estimate of Rs 1,200 crores. Unless this were done, he insisted, the third plan's resource exercises 'will not inspire the least confidence', and the 'foundation of resources' for the plan would be viewed by 'objective observers to be extremely shaky'. The realized deficit during 1960-61 (Rs 137 crores) was much smaller than planned. The actual second plan investment too, fell short of estimates by nearly Rs 130 crores.

The inflationary and balance of payments pressures encountered during the latter half of the 1950s and the associated shortfall in meeting the second plan's investment targets exerted a sobering influence on the country's planners. The third plan was conceived along altogether more modest lines. The Bank too was more closely involved with its resource exercises. The latter were intended partly to determine some 'safe level of deficit financing' at which additional investment resources were usefully mobilized without unleashing inflationary pressures. But there were two imponderables to reckon with. The first of these was the supply of wage goods—principally foodgrains—in the economy which in turn depended largely on factors beyond the control of the government and the Bank. The second imponderable, of relatively recent vintage in the reckoning of officials at the Bank, was the monetary expansion likely to result from any given increase in the latter's credit to the government.

The Bank preferred a realistic third plan financed through realizable revenue and public borrowings targets so that neither the original resource exercises nor the actual financing of the plan would involve recourse to high levels of deficit financing. It was also conscious of the risks of large publicly-funded investment projects, particularly in the infrastructure sector, facing major time and cost over-runs. Once begun, such projects could not easily be given up or suspended in the interests of short-term monetary stability. Hence the

Bank advised the government to 'err on the safer side' in determining the size of the plan and the volume of deficit financing required to finance it. The scope for deficit financing was also now more limited in the Bank's view, since the background rate of inflation was already quite high and the external reserves position, unlike at the outset of the second plan, was far from comfortable. The third plan provided for a growth in national income of 30 per cent during the five-year period. The Bank's technical staff studied the resources position for the plan both independently and as part of an inter-departmental working group, and undertook an exercise to formulate a monetary budget for the third plan. This exercise built on the Bank's own recent work on money supply in India by a working group of its economists which marked an important turning point in its understanding of the monetary impact of deficit financing.⁴ However, this understanding did not begin to exert a consistent influence on its own monetary practice until the 1980s.

On the basis of the growth rates projected in the plan document and the extension of the monetized sector it judged likely to take place during the next five years, the Bank estimated that a monetary expansion of Rs 1,000 crores would be consistent with the requirements of price stability. With an estimated money multiplier of 1.36, this called for additions to reserve money of no more than Rs 750 crores. Of this Rs 200 crores were expected to be added against the eligible assets of the private sector, leaving Rs 550 crores to be added through increased Bank lending to the government. The latter amount represented, in the Bank's view, the 'maximum level of non-inflationary deficit financing'.

The Bank had relatively little difficulty in persuading the government to accept this figure. But there was the more insidious risk that the planners' determination to 'bump up the size of the Plan' on the basis of 'assumed resources discovered by some people' would lead in the end to a much larger volume of deficit financing than the plan estimates assumed. Of direct concern to the Bank in this connection were the public borrowing estimates for the third plan. The Perspective Planning Division of the Planning Commission appears to have suggested a net market borrowing target of about Rs 1,300 crores for the plan. Since maturities during these years were expected to amount to Rs 940 crores, this translated into gross borrowings of Rs 2,240 crores (or Rs 450 crores per year). This was nearly twice the government's gross market borrowings of about Rs 1,200 crores during the second plan

⁴ See 'Analysis of Money Supply in India', *Reserve Bank of India Bulletin*, Part I (July 1961), and Part II (August 1961). The Bank's working group comprised S.L.N. Simha, V.V. Bhatt, A.G. Chandavarkar, and D.R. Khatkhate.

when maturities aggregated to Rs 385 crores and net market borrowing to Rs 816 crores. The second plan had set a net borrowings target of only Rs 700 crores and the higher amounts it managed to collect might suggest, on the face of it, that the government had been very successful in marketing its loans and that the demand for them exceeded earlier expectations. But according to a note by the Division of Monetary Research prepared on the basis of the data available to it until November 1960, the absorption of government securities *by the public* during the second plan was only about Rs 310 crores. This was adrift of the plan target by nearly Rs 400 crores and moreover, was not much higher than the corresponding first plan figure of Rs 290 crores. Of greater relevance here, the shortfall was made up by the Bank's subscriptions and by the 'adventitious aid' that became available thanks to the P.L.480 rupee resources deposited with the State Bank of India.

The Bank was convinced even in August 1957 that the second plan borrowing targets were 'quite unrealistic'. The results of the 1956 and the 1957 loan flotations were disappointing, and raised disturbing questions about the financing of the remainder of the plan. The Governor lost no time in conveying his misgivings to the Finance Minister, T.T. Krishnamachari, and at his instance, to an informal meeting of the Union Cabinet in September 1957. Despite Iengar's fears, however, the Bank managed largely to offload in the market its acquisitions of the loans the government floated or issued between 1956 and 1959. But, for a variety of reasons that need not detain us here, such sales became increasingly difficult to effect in the concluding year of the second plan. On the other hand, until the late fifties many within the Bank believed that since the government used a part of its loan proceeds to cancel ad hoc treasury bills held in the Issue Department, the Reserve Bank's subscription to central loans could justifiably be regarded as a funding operation. But this complacency did not endure the second plan years when the net creation of ad hoc treasury bills amounted to Rs 945 crores and no easy solution appeared to the problem of deficit financing. In 1961, for example, the government's borrowing during the year fell short of the budgeted figure. With prospects of borrowing in the market receding, thoughts in the government turned towards creating a new tranche of loans for issue to the Reserve Bank. The Bank was not keen to take up another special issue. It still held nearly two-thirds of the loans it had bought in 1960 and did not feel confident of being able to dispose of any further acquisitions. The volume of deficit financing, as Iengar informed the government, increased by the extent to which the Bank was unable to sell its initial subscription to a government loan:

This is a contingency to which we have more than once drawn [the] government's attention in our discussions of the loan programme, and I fear this year's operations confirm my view that the plan target is unlikely to be realized.

The Bank's views had no impact, however, on the borrowing plans of a government determined to achieve the second plan investment target. Thus apart from cash contributions (and conversions), loans to the extent of Rs 105 crores were 'specially created' for issue to the Bank so that the government might succeed in raising the budgeted amounts from the market during the last two years of the second plan.

Its experience during the second plan convinced the Bank of the need to frame the third plan's borrowing estimates too along conservative lines. Besides, with P.L.480 funds no longer likely to be available to support the central government's public borrowing programme, the Bank had good reason to apprehend that it would in the end be required once again to make good the shortfall in meeting the government's ambitious public borrowing targets through further recourse to inflationary financing. Hence it urged the adoption in the first place of a more modest public borrowing programme than the one suggested by the Perspective Planning Division. On the other hand, the resources of the banking system having grown impressively since the beginning of the second plan, banks could now afford larger contributions to government loans. Sensitive too, to the dictates of politics, the Bank recognized that 'it would not do' to reduce the third plan's net borrowing target below the original second plan estimate of Rs 700 crores. This in the event was the Bank's proposal. But the Finance Ministry increased this figure to Rs 750 crores, and later to Rs 850 crores by including in it the Rs 100 crores expected to be raised through prize bonds. This translated into a gross public borrowing target of about Rs 1,700 crores during the third plan. According to a note by M.V. Rangachari, Deputy Governor, the third plan Resources Committee 'had its work cut out in seeing that this figure was not further raised by the perspective planners'. Though 'optimistic', the final figure accepted by the Resources Committee was, in the Bank's view, not 'completely unrealistic'.

While these estimates formed the basis of the original third plan deficit financing and public borrowing projections, thanks largely to factors beyond the control of the country's economic decision-makers, the government's finances during this period went awry. Nor were the planned growth targets achieved. But the Bank's efforts to persuade the government to minimize recourse to deficit financing did not cease throughout these years. Even at the

You Said It

By LAXMAN



**When I said, "Think of a quick-
yielding project to generate
resources for our Fourth Plan,"
I did not mean this!**

—*Tol*, 21 Jan. 1965

height of the political emergency triggered by the border conflict of 1962, the Bank thought it necessary to caution the government that the effectiveness of monetary policy depended 'to a considerable extent on the direction in which fiscal policy tends'. By 1965, its views had hardened further: it was 'essential' now, the Bank declared in a note the Governor sent to Prime Minister Shastri in June,

that deficit financing be *eliminated* for the time being, or at least, reduced considerably even if it means the slowing down of certain activities or ... projects which are not of a basic character. The alternative would be a real deflation later—a course which would have very bad repercussions.

In fact, as the actual deficit in 1964–65 exceeded revised estimates presented in the 1965–66 budget, earlier hopes of ‘avoiding’ deficit financing in 1965–66 began to fade. Therefore at the instance of the Governor, P.C. Bhattacharyya, the Prime Minister, Lal Bahadur Shastri, addressed a letter to his own Finance Minister, T.T. Krishnamachari, in June 1965 asking him to take advance measures to ‘revise the outlay’ on some ‘major heads of expenditure’ so that any ‘possible shortfall in [budgetary] receipts’ for 1965–66 ‘would be counterbalanced’.

As both the food and external security environments deteriorated in the mid-sixties, the Bank’s efforts to rein in the government’s finances were far from successful, particularly as the third plan years drew to a close. Yet as noted earlier, not only did deficit financing account for a smaller proportion of the total third plan outlay than in the two preceding plans, the absolute magnitude of Bank credit to the government was also lower during the third plan than during the second. Learning further from the third plan experience, the Bank decided to examine the fourth plan arithmetic more closely than had been its wont. Internal studies convinced the Bank that the plan depended on a number of doubtful assumptions including a growth rate of over 8 per cent and an average savings rate of about 11.5 per cent. The latter implied a marginal savings rate of 18 per cent, as against about 14 per cent in the third plan. Some investment requirements, particularly for power and inventories, were also found to have been severely underestimated. The Bank was critical too of the plan’s foreign exchange budget. Let alone providing for some increase in reserves from the bare minimum levels they had reached, it left little room for error or for additional demands which might arise. Therefore the Bank proposed to the government that the plan should be ‘based on more realistic estimates of both domestic and foreign resources’ and that a ‘smaller plan’ was needed ‘if we are really serious about [avoiding] deficit financing’. ‘Material balances tables’, Bhattacharyya also pointed out to Morarji Desai, Deputy Prime Minister and Finance Minister, in April 1967, could not remain unchanged if the financial resources actually available for the central government’s plan expenditures fell short of earlier estimates. The plan should therefore be

reworked in the light of the new situation and after making realistic estimates of the possibilities in regard to overall income growth, scope for modifying the existing savings–income ratios, trends in foreign trade and payments, etc.

The Bank’s ‘recalculations’, according to Bhattacharyya, suggested a plan size of Rs 19,000 crores rather than the Rs 23,750 crores proposed in the

fourth plan's draft outline. In the event, circumstances conspired against the original fourth plan which in the end had to be abandoned.

By the mid-sixties the Bank was beginning to raise its sights. As mentioned above, it was now inclined to consider ways of 'eliminating', rather than as earlier merely restricting, deficit financing. This was of course easier said than done, and though the Bank's net credit to the government represented a smaller proportion of the annual plans' outlay than of the three completed five-year plans, the journey was not uneventful or without setbacks. The budget for 1966-67, for example, assumed market borrowings of Rs 280 crores. But the Bank, which continued to subject the government's borrowing operations to close scrutiny, was of the view that Rs 225 crores represented the more realistic figure and that the budgeted amount would not be realized unless the Bank made a cash subscription of Rs 65 crores. This, the Deputy Governor, B.N. Adarkar, remarked, would be 'inconsistent with the general tenor' of the Bank's credit policy. The Governor also pointed out that he could not 'justify the R[eserve] B[ank] putting another 65 crores this year when we have not been able to unload any securities subscribed last year'. The Bank managed, in the event, to convince the government to reduce the size of the 1966 flotations to Rs 260 crores; and thanks to the success of Bhattacharyya's personal efforts to persuade the Life Insurance Corporation and some quasi-public bodies such as the Bombay Port Trust to increase or maintain their contributions, it managed to hold its own cash subscription down to Rs 37 crores. But the Bank's success in these respects was more than undone, however, by the unprecedentedly large volume of ad hocs created during the year, their net issue of Rs 260 crores in 1966-67 representing until then the largest addition to the Bank's holdings of these bills in any single year.

DEFICIT FINANCING AND INFLATION: THE BANK'S VIEW

The Reserve Bank of India's understanding of inflation during much of our period was more structuralist than monetarist in the narrow sense of the term. Officials at the Bank were sensitive to a number of structural factors which, in the short and medium term, mediated the relationship between explanatory variables such as public expenditure, change in the government's indebtedness to the Reserve Bank, and changes in money supply on the one hand, and the rate of inflation on the other. The arguments the Bank brought up in its discussions with Per Jacobsson, though intended merely to highlight some characteristics of the Indian monetary system, already had a structuralist ring to them. Other considerations which the Bank understood to influence

the price outcome of any given policy included changing income distribution and the availability of foreign exchange, the latter not being viewed as solely a monetary variable. But by far the most important of such factors were bottlenecks in the wage goods, intermediate goods, and infrastructure sectors, an influential Bank study citing discontinuities in the 'aggregate supply function ... [due to] structural rigidities' as a feature affecting the impact of monetary policy in a developing economy such as India's.⁵ In keeping with this line of 'structuralist thinking', the Bank believed that while monetary policy worked to 'dampen the pressures originating on the side of demand' to the extent the latter exceeded supply, it could not

by itself ... be expected to restore balance in prices when the underlying trends make for increase either due to forces on the supply side or due to the impact of other factors such as fiscal deficits operating on demand.

The above diagnosis yielded a prescription which underlined the complementarity between fiscal and monetary measures even to curb inflationary tendencies. But the Bank was also usually at pains to emphasize longer-term measures which would give the country's economic managers greater physical control over the functioning of key markets such as those for foodgrains. Thus, despite harbouring some reservations about the inflationary impact of buffer-stock financing, the Reserve Bank was generally supportive, particularly as some of the wider structural constraints began discernibly to affect the economic environment, of policies to guarantee minimum prices to cultivators and maintain buffer stocks of the most important wage good—foodgrains.

Inevitably, the Bank's structuralist, rather than narrowly monetarist, perspective influenced the formulation and execution of its monetary policies. It might also be said to have had important longer-run consequences for the structure of the Indian financial system. On the one hand, policy could never be indifferent to what might be regarded as the genuine needs of the productive sectors of the economy. Thus while credit which might fuel speculation in essential commodities might have to be squeezed, the needs of the infrastructure sectors or the demand for credit to build a buffer stock of foodgrains could not for instance be overlooked even in an environment otherwise characterized by monetary tightness. This meant in turn considerable flexibility in the deployment of the traditional instruments of monetary policy, and some innovation in the development of new ones. Instruments which worked in a

⁵ V.G. Pendharkar and M. Narasimham, 'Recent Evolution of Monetary Policy in India', *Reserve Bank of India Bulletin*, April 1966, pp. 340–61.

generalized way, such as the Bank rate, were sometimes viewed with reservation because they were feared to 'discourage developmental activity in the private sector, ... lower the prices of Government securities and therefore raise the cost of future Government borrowings'. Far better in the circumstances to deploy selective instruments which favoured borrowing for essential purposes and penalized borrowing for non-essential or speculative ones.

Views such as these were already present both within the Bank and outside from the early 1950s. For example, as pointed out earlier, even the otherwise modest first plan document had ambitious expectations from the central bank of a planned economy. The central bank, the plan document affirmed, could not confine itself merely to a 'negative regulation' of the 'overall supply of credit', but should instead direct it into the desired channels. Despite high rates of inflation in the intervening years, this view of the role of central banking was reinforced as the country came face to face with a daunting set of simultaneous economic and military challenges during the 1960s. The underlying logic and the actions flowing from it culminated in the policy of directed credit and interest rate regulation which, for better or for worse, became important features of the Indian financial system for over three decades thereafter.

DEFICIT FINANCING AND MONETARY CONTROL

The public investments initiated during the second plan and sustained during the third imposed a number of responsibilities on the Bank. These included helping the central and state governments to raise resources in the market and keeping them in funds. The Bank's roles as banker to governments and manager of their loans (discussed in greater detail elsewhere) had several important implications for the conduct of its monetary policies. In the beginning the Bank had maintained a reserved and watchful stance, more especially in relation to the debts of state governments. Although caution was not entirely forsaken, from the mid-fifties the Bank grew noticeably more indulgent towards the financial needs of the public sector. Partly, of course, the new approach reflected the intellectual attractions which the government's plans for economic development held even for officials within the Bank. But there were also limits to how far the Bank could resist the winds blowing from Delhi, especially if by doing so it ran the risk of losing all influence over the government's economic policies.

Hence, whatever its reservations—and these were not inconsiderable nor were they always smothered in silence—the Bank remained willing, on the whole, to meet the public sector's demand for resources, even if that meant

rationing credit to the private sector. Their acquiescence in the proposals the central government made in January 1955 for the financing of its ways and means aptly illustrates how Bank officials viewed monetary policy priorities during these years. Not long afterwards Parliament passed legislation to abandon the fractional reserve system in favour of a more elastic system of note issue. Necessary as this change was to meet the currency requirements of an expanding economy, the Bank was largely unmindful even at this time of the quality of the Issue Department's assets portfolio and of the nature of the domestic assets which replaced foreign assets in it. Finally, even while giving up fractional reserves, the Bank acquired the power to vary reserve requirements so that it could regulate the impact of large public expenditures on the ability of the banking system to expand credit to trade and industry. Although, as noted above, the Bank grew more vocal subsequently in giving expression to its reservations about the direction of the government's financial policies and its advice did not always go unheeded, its complaisance in the matter of ad hoc treasury bills—as well as more generally—blunted the edge of its criticism. The former also opened the floodgates to 'automatic monetization' and in the longer run to the inflationary financing of budgetary deficits by the Reserve Bank.

DEFICIT FINANCING AND ASSETS OF THE ISSUE DEPARTMENT

The Bank extended credit to the central government either against dated securities or against ad hoc treasury bills. The Bank might pick up the securities at the time of their issue or subsequently, to hold as part of its own portfolio or in order to unload them later on a more receptive market. The dangers of inflationary financing were not altogether absent in the case of dated securities: although the Bank and the government did much to assist the growth of a secondary market for the latter's loans—one which in later years became increasingly captive—there was, as we saw above, always some risk that these assets might not command a ready market outside the Bank. But the principal risk of inflationary financing of the government's expenditures arose from the latter's practice of issuing ad hoc treasury bills to the Bank in order to keep itself in funds.

Creating Ad hoc Treasury Bills: The Arrangement of January 1955

Under its Act, the Bank is authorized to make advances repayable within three months to the central and state governments. The Bank's advances to the central government during our period were made against the issue of ad hoc treasury bills. The latter made their first appearance in 1920 when the Government of India issued them to the Currency Department (the precursor

of the Bank's Issue Department) to minimize the domestic deflationary impact of reserve losses sustained to finance a prolonged flight of capital that year. They were created for the first time after the founding of the Bank during the second world war. Ad hoc treasury bills for about Rs 293 crores were also created in 1948-49 to replace sterling securities in the Issue Department transferred to the British government in the wake of the 1948 sterling balances agreement. While ad hocs created during the war were soon retired with the proceeds of dated loans, those created in 1948-49 were largely renewed on maturity, and remained outstanding to the tune of Rs 253 crores at the end of March 1954.

To the extent ad hoc treasury bills were funded or retired by issues of dated debt to the public, monetary expansion against them was not intrinsically a more inflationary form of financing than that against dated securities held in the Bank's Issue Department. Indeed, from July 1958 ad hoc treasury bills were funded in a limited way every year, the total volume of funding between then and March 1967 amounting to Rs 825 crores. But apart from the conditions in the market for the government's long-term debt, the prospect of funding ad hoc treasury bills into traded gilts, and consequently their potential for inflation, turned crucially on the volumes in which these assets were issued.

The Reserve Bank of India Act merely enabled the Bank to make short-term advances to the central government. It did not *require* the Bank to make such advances. But in January 1955, the Bank agreed, rather somnolently and without much serious thought, to a suggestion of the Finance Ministry to create ad hoc treasury bills in such a manner as to ensure that the central government's cash balances did not fall below Rs 50 crores at the end of each week. The availability of soft credit in unlimited quantities from the central bank through the creation of ad hocs helped undermine financial discipline at the centre. It also seems to have encouraged state governments to draw unauthorized overdrafts from the Bank. In due course the latter were 'regularized' by the centre making grants to overdrawn state governments, these grants themselves often being financed through the creation of fresh ad hoc treasury bills. In this way, the Bank became a source of cheap credit not only for the central government, but also indirectly for state governments.

The initiative to create ad hoc treasury bills to ensure that its cash balances did not fall below some minimum at the end of each week came from the Government of India. Writing to G. Balasubramanian, the Secretary of the Bank, on 8 January 1955, H.S. Negi, a Deputy Secretary at the Finance Ministry, pointed out that the government assumed a

minimum working balance of Rs 50 crores in its ways and means estimates, and that since the balance had fallen to Rs 40 crores, the Bank should 'arrange to have ad hocs issued to the extent of Rs 10 crores'. Two days later, Negi wrote another letter to Balasubramanian in which he enclosed the 'usual ways and means forecast' of the government for January and February 1955, and pointed out that in order to maintain the central government's cash balances with the Reserve Bank 'in the neighbourhood of Rs 50 crores at the end of every month', it was necessary to create 'new special ad hocs' of about Rs 30 crores in January 1955 and Rs 20 crores in February 1955. Then followed a telephone conversation between the two officials, the upshot of which was that the Bank agreed 'in future' to 'create ad hoc treasury bills in suitable blocks to the extent necessary in order to maintain [the] Central Government's cash balance roundabout [sic!] Rs 50 crores on Fridays'. This was reiterated by the two sides in May 1955 following a pointed query from the Bank about the government's ways and means forecast for the month which assumed a closing balance of less than Rs 50 crores. With the Deputy Governor, Ram Nath, and Rama Rau himself endorsing the 'standing instructions' in January 1955, the matter of extending credit to the central government was thereafter handled at the operational level, with the decision to create ad hoc treasury bills whenever necessary before books were closed on Fridays resting, for all practical purposes, with the Reserve Bank's Manager in Calcutta and its Secretary in Bombay.

Abandoning the Proportional Reserve System

Section 33 of the Reserve Bank of India Act, as adopted in 1934, provided for an inflexible domestic currency system based on a proportional reserve under which two-fifths of the assets of the Bank's Issue Department were required to be held in the form of gold coin, gold bullion, or foreign securities. Of these assets, at least Rs 40 crores were to be in the form of gold coin and bullion. Currency was the predominant component of money supply in India, and the proportional reserve system afforded little scope for expanding it except by running a payments surplus. With the accelerated development effort expected to increase the demand for currency and the second plan projecting a sharp decline in the country's foreign exchange reserves, the current provisions of the Reserve Bank Act looked likely to hamper the authorities' ability to meet this demand. On the other hand, while it was possible to achieve an elastic currency system by allowing domestic assets to be substituted for foreign assets in the Issue Department, the substitution might have some implications for monetary stability. In addition, as existing

currency cover provisions were being relaxed through a legislative amendment, the Bank was confronted with the problem of finding eligible *domestic* assets against which the note issue could be expanded.

The proportional reserve system was largely a relic of pre-war currency arrangements. By the early 1950s, the view had gained ground that the principle of tying note issue to the size of a country's exchange reserves represented an unnecessary complication in monetary arrangements. Moreover, while yielding a return, idle exchange reserves represented a cost to the economy in the form of investment and growth foregone. Since the main function of exchange reserves was to finance a temporary balance of payments deficit, the former's size ought to be related, in this view, to the likely extent of instability on the external account rather than to the size of the note issue. On the other hand, countries which adopted a proportional reserve system either tied up their foreign exchange reserves unnecessarily or were obliged to change their legal provisions frequently. Following this line of reasoning, several countries did not prescribe any minimum holdings of gold or foreign exchange against the note issue. Far from encouraging fiscal profligacy as many contemporaries feared, the new system only increased the responsibility of the authorities to maintain domestic and external stability through an appropriate mix of policies.

The initiative to reconsider India's currency cover provisions in the light of more modern requirements came from the government. In a letter he wrote to Governor Rama Rau in the summer of 1955, B.K. Nehru, Joint Secretary in the Finance Ministry, reflected that unless changed, the existing provisions would impose a 'very sharp limit' to deficit financing and the country's ability to run a payments deficit. Outlining three alternatives—lowering the proportional cover, moving towards a fiduciary system, or doing away altogether with the statutory requirement of a currency reserve—Nehru indicated the government's preference, subject to the Bank's views, for a simple fiduciary system. The Finance Ministry was also eager that whatever the change proposed, it should be made 'long before the need for it begins to be felt so that no question of a crisis of confidence may arise when the law is amended'.

Besides envisaging deficit financing of the order of about Rs 1,200 crores, the second plan as already pointed out anticipated that the country's foreign exchange reserves would be drawn down by about Rs 40 crores each year. An imbalance of this magnitude would, under the existing provisions, reduce the Bank's power to issue notes by Rs 100 crores annually; so that, according to a memorandum to the Bank's Central Board, at the current rate of expansion of note issue, 'the available foreign reserves in the Issue Department would fall below the legal requirement in a little over a year'. If gold held in the

Issue Department and valued in its books at 8,47,512 grains of fine gold per rupee was revalued on the basis of the current rupee parity of 2.88 grains per rupee, an additional cover of about Rs 80 crores would become available, but even this would soon be inadequate. Hence the Bank needed little persuading that a change in the statutory provisions on currency cover was necessary.

In reviewing various alternatives, the Bank concluded that rather than adopt a fiduciary system as the Ministry proposed, it would be best to entirely dispense with the statutory requirement for currency cover. The Bank's argument, as set out in a note by its Economic Adviser, B.K. Madan, was that no statutory provisions concerning note issue could safeguard against the possibility of a 'substantial inflationary movement', more so as commercial banks' deposit liabilities, which were potentially the most dynamic component of money supply, were unaffected by them. While a proportional system where currency expansion was hostage to the economy's ability to generate a current account surplus could no longer be justified, there was in Madan's view, no advantage in replacing it with a fiduciary system. In the first place, even with the present proportional system, the note issue could rise to Rs 2,075 crores after the gold held in the Issue Department was revalued. Hence a fiduciary system would not make the note issue more elastic unless the limit was set at Rs 2,100 crores or more. But setting a limit so much higher than the present note circulation of about Rs 1,350 crores would 'confound public opinion, and give a greater shock to confidence than the removal of the cover provision'. In general, he pointed out, it was more consistent with the logic of the fiduciary principle to relax the limit as the need arose rather than in advance of it. In the longer run, a fiduciary system would require regular and repeated relaxations of the limit whether through parliamentary approval or executive action, with the accompanying risk of damage to the public's confidence in their currency system. Deleting the statutory provision would, on the contrary,

cut the Gordian knot once and for all, and subsequent assessment of the economic and monetary situation would be facilitated in terms of the total picture rather than of a figure ... [whose] significance ... might be magnified out of proportion to its relevance.

Madan also rejected the argument that note issue restrictions were an 'effective safeguard against the misuse of political power'. Not only was it a mistake to suppose currency to be the sole, or even principal arena of mischief, a 'formal restraint of limited efficacy' on currency expansion would be of little use

where the government was 'unmindful of its responsibilities to the country'. Far from the proposed move being a 'derogation' of Parliament's authority, it would enable the latter to be better 'exercised in ... enforcing the general responsibility of Government rather than only in formal fulfilment of a Section, ... [whose] essential rationale ... has been greatly modified ...'

However, in conveying its recommendations to the government the Bank preferred to make a less radical departure than the one Madan had argued for. In doing away with the present legal provisions, the Bank proposed that the government prescribe a 'minimum currency reserve, say Rs 300 or Rs 400 crores', which did not vary with the note issue. There was no 'theoretical basis' for such a practice, only the practical consideration of maintaining public confidence in the currency 'especially when we are resorting to deficit financing on an appreciable scale'. A minimum level of Rs 400 crores (£300 million) besides being practically the same as the amount earmarked as a currency reserve in the sterling balances agreement concluded between the Indian and British governments in February 1952, was also thought to give the authorities a reasonable cushion to finance the second plan (foreign exchange reserves aggregated about Rs 875 crores at this time) without arousing fears of a drain of these reserves such as might arise were the cover provisions to be entirely removed. The Bank added that the opportunity should also be used to revalue the gold in the Issue Department. The timing of these changes needed careful consideration, however, keeping in mind their possible repercussions on public confidence.

The government accepted the Bank's recommendations, with the proviso that the fixed currency reserve should consist of Rs 100 crores in gold, which was simultaneously to be revalued, and Rs 300 crores in foreign securities. The Bank was to keep, in addition, a foreign currency reserve of Rs 100 crores. If at any time the gold and foreign balances of the Issue Department fell below Rs 500 crores, the Bank would 'enter into immediate discussion with the Government of India as to what should be done about the situation'.

While in general agreement with the government's revised proposals, the Bank reflected that any reduction in the minimum gold reserve from the current (revalued) level of about Rs 118 crores to the suggested level of Rs 100 crores was liable to provoke misrepresentation and controversy. It saw no reason besides, to split the foreign exchange holdings of the Issue Department into a minimum reserve of Rs 300 crores and an additional reserve of Rs 100 crores, preferring a single consolidated reserve of Rs 400 crores. The Bank also suggested a simultaneous amendment to section 37 of the Reserve Bank of India Act, to enable these asset requirements to be suspended with the prior consent of the government for a period of six months in the first instance, and

subsequently for three-month periods, on the condition that the maximum reserve deficiency would not exceed Rs 100 crores and that the minimum gold reserve was at all times maintained. Alongside these changes, the Bank proposed repealing an archaic provision in the same section of the Act requiring it to pay a tax to the government in the event of the Issue Department's gold and foreign exchange reserves falling below the prescribed minimum. With the Bank having passed into public ownership and its surplus profits now payable to the government, this provision had lost all significance. Except for suggesting the minor modification of fixing the minimum gold reserve held in the Issue Department at Rs 115 crores, the Bank's final proposals were accepted by the government.

The amendment bill sparked off a lively debate in Parliament. Although the bill proposed a number of other important amendments including that to enable the introduction of variable reserve ratios (discussed below), the measure to relax the proportional reserve requirement aroused wide interest and comment. Criticism of the proposed cover provisions was along predictable lines. M.S. Gurupadaswamy thought it was a prelude to 'currency chaos' since it removed all safeguards on currency expansion. G.D. Somani also expressed a similar fear, while V.B. Gandhi deplored the fact that the Reserve Bank was going 'too far too fast.' It had put itself in a position where it could no longer say 'No' to the government and force the Finance Minister to come to the Parliament which in 'certain circumstances', he averred, 'should retain some control over the actions of Government in these monetary fields' Similar views were expressed in the Rajya Sabha where, however, the debate was much wider-ranging. Ironically, and as if to allay the apprehensions Ambegaokar had voiced in an internal note about 'revolutionary' parties abusing the new provisions should they come to power, Bhupesh Gupta of the Communist Party of India anticipated the Bank's evolving approach towards deficit financing and pointed out that the second plan's price assumptions were already being belied, giving rise to doubts about the ability of public investment to create durable income-generating assets in the community. Other members feared that the new provisions might enable a weak government to take recourse to inflationary financing and evade parliamentary control over its spending.

The Reserve Bank of India (Amendment) Act, 1956 became law on 6 October 1956. Within months of its passing, however, the new currency cover requirements proved less flexible than authorities had hoped. The balance of payments situation worsened with unexpected rapidity, the country's foreign exchange reserves having to be drawn down by Rs 262 crores in 1956-57 alone (as against Rs 96 crores for the entire first plan period). In the

circumstances, Iengar judged it necessary to inform the Central Board in April 1957 that in the absence of any drawings from the IMF, India's foreign exchange reserves could be expected to fall to Rs 445 crores by the end of June. The following weeks revealed the Governor's projections to have been optimistic and by July despite drawings from the Fund, reserves appeared in danger of piercing the new floor within weeks. By the end of July it became clear that 'there was no prospect' of any escape from suspending even the new section 33 requirement, and the Bank sought and obtained the government's approval on 30 July 1957 to relax its application for six months. This was a well-judged precaution, as gold and foreign securities held in the Issue Department dropped below Rs 400 crores on 2 August 1957 following a transfer of Rs 25 crores to the Banking Department. But reserves continued to decline at the rate of about Rs 9 crores each week and, as Iengar pointed out to the Central Board, not only was there no realistic hope of reserves being restored soon to the statutory minimum level, at the present rate of withdrawal even the additional Rs 100 crores that had become available would not last more than three months.

A further modification of the section 33 requirement was the obvious next step. The idea of doing away with the minimum (foreign exchange) balance provision was abandoned no sooner was it considered, for fear of its likely effect on public confidence in the changed situation. Such a step might equally create an impression abroad that the Indian authorities had given up all hope of controlling the drain. Besides, a minimum reserve provision might have some 'braking effect' on the government's ability to spend beyond visible means. However, Iengar also insisted that the new provision should be realistic and enable the Bank to carry on for a reasonable length of time without approaching the government repeatedly for its relaxation.

Though various other figures were talked about, the government decided in the end to prescribe a minimum reserve of gold and foreign securities of Rs 200 crores, of which an irreducible minimum of Rs 100 crores (on second thoughts raised to Rs 115 crores to preserve the status quo in this respect) was at all times to be held in the form of gold. Further, no lower limit of foreign securities was to be laid down in the event of an emergency covered by section 37 of the Act. Following the Committee of the Central Board approving these amendments, they were issued as the Reserve Bank of India (Amendment) Ordinance, 1957 on 31 October 1957, barely a year after the 1956 amendment bill passed into law. The Reserve Bank of India (Second Amendment) Act, 1957 passed to replace this ordinance further empowered the Bank to reduce its holdings of foreign securities in the Issue Department to any lesser amounts with the prior sanction of the government. Although debated and passed in

rather more controversial circumstances than its predecessor amendment Act, the bill aroused comparatively little opposition. The Finance Minister, T.T. Krishnamachari, sought to make a virtue of necessity by declaring in his speech introducing the bill that the country's foreign exchange reserves were useful only if they were freely available to be drawn in times of emergency and difficulty. In immobilizing so large a part of the reserve the country was foregoing its freedom for no obvious benefit. Allaying fears that the latest changes were a recipe for inflation which the Bank now lacked the power to check, he stressed that between the Parliament and the Reserve Bank, the system provided 'adequate machinery for exercising such vigilance as may become necessary from time to time in regard to the overall supply of monetary media in the economy'.

More Ad-hocism: The Search for Domestic Assets to Back Note Issue

Shortly after its decision to change the existing provisions for currency cover, the Bank was confronted with the problem of an imminent shortage of *domestic* assets for the Issue Department. Thanks to growing public and private investment expenditure, the demand for currency, which represented the liabilities of the Bank's Issue Department, rose steadily and the Bank apprehended that its ability to meet this demand would soon be constrained by the shortage of matching assets. The government's deficit financing operations and a payments surplus could both lead to increased demand for currency, but they also made matching assets (ad hoc treasury bills and foreign securities respectively) available to the Issue Department. From early in the second quarter of 1956, sterling securities were being depleted rapidly while bank credit to the private sector, financed largely by borrowings from the Reserve Bank of India, expanded. In the first instance these borrowings went to swell the assets of the Banking Department, but as they were withdrawn from the banking system in the form of currency, pressure was placed on the liabilities of the Issue Department. The Bank expected this pressure to increase, since in the wake of surging inflationary expectations during the past busy season, over three-quarters of the rapidly increasing money supply had taken the form of currency.

As noted above, the assets of the Issue Department were governed by section 33 of the Reserve Bank of India Act. Under subsection (3) of this Act, apart from gold coin, gold bullion, foreign securities, rupee coin, and rupee securities, assets of the Issue Department were to be held in the form of 'bills of exchange and promissory notes payable in India' which were eligible for purchase by the Bank under sections 17(2)(a), (b), and (bb), and 18(1) of the Act. While the last was an exceptional clause to be invoked only on 'a special occasion' or in an

emergency, such as for example a run on one or more banks, the other two sections allowed the Bank to purchase and rediscount bills of exchange and promissory notes arising out of legitimate commercial, trade, or seasonal agricultural operations. In practice however, the bulk of the Bank's lending to commercial banks was carried out against assets under sections 17(4)(a) (typically promissory notes issued by scheduled banks discounting government securities) and 17(4)(c) (documents pledged to the Bank under the bill market scheme) which were not eligible to be held in the Issue Department.

In May 1956, the Bank's officers began considering several means of tackling this problem. It seemed the longer-term solution lay either in assets created under sections 17(4)(a) and (4)(c) being made eligible as cover in the Issue Department or, carrying the measure one further step, doing away with the distinction between the Issue and Banking Departments. There were arguments in favour of both courses of action, but B.K. Madan objected to admitting in the Issue Department, assets 'which are known to assume large dimensions during a part of the year' since it would be 'definitely interpreted as throwing the floodgates of inflation wide open'. In contrast, although the abolition of the 'historic' distinction between the two departments was seemingly the more radical response, in the event of its adoption attention would be directed to 'general organizational aspects' and the 'public eye' might miss the 'particular part of the reform which helps the problem now under consideration'. Legislation in either event would be a long-drawn-out process. But a possible source of immediate relief lay in writing up the gold held in the Issue Department from its present book value of Rs 21-3-10 per *tola* to the official value (equivalent to \$35 per ounce) of Rs 62-8 per *tola* and retransferring the assets retired with these profits to the Issue Department pending the latter's final disposal.⁶

Views were also canvassed regarding a quick-fix solution—that of having the government issue ad hoc treasury bills in excess of its requirements. To some Bank officials in 1956 this solution appeared to offer more lasting relief than the transfer of revaluation profits. Besides it was easier to implement since, unlike changes in asset eligibility criteria or doing away with the distinction between the Banking and Issue Departments, no protracted legislative procedures were involved. There was, as we saw above, already an arrangement between the Bank and the government to create ad hoc treasury bills whenever the latter's balances with the Bank dropped below Rs 50

⁶ As the Bank's officers understood the legislation at the time, they were obliged to transfer the revaluation profits to the government, at the end of the month of June following the revaluation. For various reasons which need not be gone into here, the Bank preferred the profits to be deposited with it in a Special Reserve Account.

crores. A mere extension of this understanding, some officials at the Bank felt, would suffice for the purpose in view. On the other hand this would require suspending the practice the Bank followed of cancelling ad hoc treasury bills whenever the government's cash balances with it exceeded Rs 60 crores. Besides, other officials at the Bank, especially in the Research Department which was not consulted about the arrangement of January 1955, had grown wary of the consequences of expanding Bank credit to the government against ad hoc bills in an unregulated manner. Madan was unequivocally disapproving of a 'highly unsound' scheme which if carried into effect would oblige the government to increase its indebtedness to the Bank even when it had no need for the additional resources, indeed on the understanding that the government would not use its balances with the Bank for its own purposes.

Largely for reasons of public psychology and the distrust that might be evoked, opinion at the higher levels of the Bank was averse to doing away with the distinction between the Issue and Banking Departments. Expanding the class of assets which could be held in the Issue Department was regarded the more acceptable solution and it was decided to combine the legislative amendment required for the purpose with that enabling the Bank to retain the profits of gold revaluation in a separate reserve. But on further reflection it transpired that the Bank had earlier been wrongly advised and that it could retain the revaluation profits without the necessity of any amendment to its Act.

Even before this was known however, the Chief Accountant's Department had begun to dictate the course of events. Since April 1956 when this department first raised the 'purely hypothetical' prospect of a shortage of assets in the Issue Department, its officials favoured creating ad hoc treasury bills to overcome the problem, if necessary refunding to the government the discount charged on ad hocs to avoid straining its revenues and to weaken any resistance it might offer to the novel proposal. A note by V.G. Wagle in August 1956 carried this argument further, observing that, contrary to official claims and the Bank's fears of deficit financing on a large scale, 'the net amount of ad hocs actually created' during the first plan and the first four months of the second plan was 'only Rs 250 crores'. The note added that the large blocks of ad hocs the government created especially in March and September to pay states their shares of its revenues were mostly cancelled after state governments, which often had no immediate use for these receipts, invested them in central government treasury bills. 'The effect of the initial creation is, therefore, nullified by the subsequent cancellation and from our point of view these transactions have no particular significance.' Ambegaokar seems to have been persuaded by Wagle's argument, for he took up the

matter with the Finance Ministry on his next visit to New Delhi in August 1956. As Ambegaokar wrote, it was agreed at the meeting he held with officials at the ministry that, depending upon the Bank's needs, the government 'would be prepared to allow ad hocs to be created for our purpose or to maintain a larger cash balance for the time being'.

The Bank's Department of Research and Statistics, whose views had once again been ignored, fought a rearguard battle against this move. A detailed note by S.L.N. Simha in September 1956 pooh-poohed fears of a shortage of eligible domestic assets in the Issue Department and argued that no problems were likely to arise on this account for more than a year. He also drew attention to the 'persistent tendency' for rupee securities, 'representing mainly the creation of ad hocs' to increase in the Issue Department, and insisted that nothing should be done to encourage this trend. These views, as we have seen, already had Madan's support. But the die was cast. Ambegaokar appears to have felt confirmed in his earlier judgement by the new legal view, which now placed the Bank in the delicate position of having to seek another legislative amendment, this time for the sole purpose of modifying once more its rules of note issue. Not wishing to provoke further controversy the Bank shied away from such a step. In the Deputy Governor's view, the amendment would be unnecessary if the Bank could, as earlier agreed, 'rely on the Government coming to our assistance by allowing currency to be created against ad hocs in an emergency arising for a short while in the busy season'.

Rethinking on Ad hocs

Inexplicable as the Bank's eagerness to hold these assets might appear, it is sobering in retrospect to reflect that ad hoc treasury bills were seen at the time as a convenient means of keeping the government in funds, and later as a solution to what appeared to some officials at the Bank as a mere accounting problem in the Issue Department. The Bank's Research Department was not consulted in January 1955 and it was opposed to the course of action which the Bank proposed in August 1956. But its intervention failed to have any effect. Early in July 1957, Jengar was concerned enough to draw the Finance Minister's attention to a state of affairs where the creation of ad hoc treasury bills to maintain the government's closing balance each week had become a 'merely ... mechanical process', and no checks existed on the government's ability to spend without regard to the available resources. This was a recipe for disaster should a 'weak or careless Finance Minister' take office in Delhi. 'As matters now stand', the Governor declared, 'with an automatic expansion of currency at the will of Government, the Bank ... is not really in a position to discharge ... [the] responsibility' vested in it by statute of regulating 'the issue of bank

notes ... with a view to securing monetary stability in India'. Krishnamachari responded by rejecting the French practice to which the Governor had alluded in his letter, of subjecting the financing of the central government's ways and means to any 'rigid procedure'. The creation of ad hoc treasury bills was limited by the extent of the government's deficit financing proposals which were discussed with the Bank and had Parliament's approval. Declaring that the Reserve Bank would thus have 'every opportunity of discharging its responsibility of regulating the issue of Bank Notes ... with a view to securing monetary stability', the Finance Minister hoped that the Governor would be 'satisfied' so long as discussions about the government's borrowing programme and ways and means requirements 'took place in good time to enable the Reserve Bank to tender its advice ... [to] the Government'. Although consultations such as those suggested in Krishnamachari's letter did take place from time to time, the absence of any formal checks on the issue of ad hoc treasury bills greatly weakened the Bank's ability to influence their outcome.

Jengar's fears about the 1955 arrangement were not realized until after the end of the years covered by this volume. But despite Krishnamachari's assurances to the Bank, there were already signs during the second plan years that this facility was helping to loosen the purse-strings of the government. The net issue of ad hocs (i.e. those created less those cancelled) during the first plan years amounted, as noted earlier, only to Rs 250 crores. This figure shot up to Rs 945 crores during the second plan. Though it dropped to Rs 800 crores (or an average of Rs 160 crores per year) during the third plan, it rose once more to Rs 260 crores in 1966-67.

As pointed out above, the government agreed, largely at the Bank's insistence, to begin funding ad hoc treasury bills to a limited extent from July 1958 when the latter made up over 99 per cent of all securities held in the Issue Department. Ad hocs to the extent of Rs 300 crores were funded in July 1958 and Rs 150 crores in December 1959. Thereafter ad hocs of Rs 50 crores were funded each year (with the exception of 1963-64 when funding operations mopped up Rs 75 crores), the stated object being to continue operations at this level until the total volume of ad hocs outstanding was reduced to Rs 500 crores. But thanks to the rapid growth in the issue of ad hocs witnessed during these years, funding of this magnitude proved insufficient to make any impact on the Bank's holdings of these bills which rose steadily through the period covered by this volume to amount to about Rs 1,600 crores at the end of March 1967. Besides, the depressed conditions that overcame the gilt-edged market not long after funding began also helped attenuate the impact of the Bank's funding operations on the size of its net credit to the central government.

VARIABLE RESERVE REQUIREMENTS

Its founding Act gave the Bank few powers of direct control over the credit mechanism of commercial banks. But with increased public expenditure, rise in bank deposits, and the spread of the banking system, the Bank judged such control vital to effective monetary management. The power to vary commercial banks' reserve requirements was the additional instrument the Bank sought for the purpose. Taking this power required an amendment to the Reserve Bank of India Act, and the Bank took the opportunity yielded by the amendment on currency cover provisions to effect the necessary change in the Act.

Already since the war, officials at the Bank were in the practice of monitoring trends in the growth of banks' deposit liabilities and in the ratio of deposits to the total money supply. In India as in other countries with an underdeveloped banking system, currency was the predominant component of money supply. But the ratio of currency to money supply showed considerable short-term fluctuations. Experience indicated that the long-run trend in this ratio would be downward, but also that factors such as the rate of inflation could induce contrary trends in the shorter term. More than many other countries, India had been in the grip of price instability since the late 1920s and the ratio of currency to money supply mirrored this instability. After dropping sharply in the depressed 1930s the ratio rose through the inflationary war years, falling after the war ended before rising slightly in a rather belated reaction to the Korean boom. Thereafter the ratio remained mainly stable at around two-thirds until the late 1950s, rising from 1958–59 to peak in 1960–61 at about 70 per cent before falling off gradually thereafter.

To the Bank's officials, however, the latter developments were still in the future. In the mid-fifties they were faced with the expectation, or knowledge, of large deficit-financed investment outlays. The resulting increase in the demand for monetary media could be expected, in the first instance since the Indian economy comprised a large non-monetized sector and 'banking contact' did not coincide with 'trading contact', to take the form of a rising demand for currency. The expansion of the banking system would not immediately affect this 'cash drain' since in the initial stages banks too were likely to be merely another 'distributing agency for the note issue'. The preference for currency would be reinforced if the large plan outlays led to higher rates of inflation. Hence the reading within the Bank was that the ratio of currency to money supply would 'rise somewhat' at least for the foreseeable future. In the event, as the figures cited above show, the Bank's prediction of the likely future trend of the ratio was largely confirmed by later developments.

Though the impact of deficit financing was likely to be felt largely on currency, the Bank could not be indifferent to the rapid growth in the volume of bank deposits since the early 1950s. Deposit growth accelerated particularly from about the end of 1953, rising by a third within the next three years. Although there were some signs thereafter of a possible slow-down in deposit growth, there was little certainty about future trends. The banks' reliance upon Reserve Bank accommodation, markedly up since the inception of the 'new monetary policy' in November 1951, continued to grow. While this was propitious from the point of view of control over commercial bank credit, the Bank however apprehended that the government's deficit financing operations might undermine this prospect by placing 'independent resources' in the hands of commercial banks. Thus freed from having to depend on the central bank for accommodation, banks might prove less amenable to its control. By about the middle of 1955, therefore, desultory consultations were already under way within the Bank concerning the efficacy of varying reserve requirements in checking the expansion of commercial banks' credit.

Commercial banks operating in India have traditionally been subject to two types of reserve requirements. Under section 24 of the Banking Companies Act, all banking companies were required to hold at least a fifth of their time and demand liabilities in India in the form of cash, gold, or approved unencumbered securities. Although this stipulation did have implications for the banks' ability to expand credit, its object however was to preserve banking stability by ensuring that banks had enough liquid reserves to meet a drain, should one arise, on their resources. Besides, scheduled commercial banks were required, under section 42 of the Reserve Bank of India Act, to maintain with the Bank comparatively low minimum balances of five per cent of their demand liabilities and two per cent of their time liabilities, the latter reserve being counted as part of the banks' liquid reserves for the purposes of section 24 of the Banking Companies Act.

The Banking Companies Act did empower the Reserve Bank of India to regulate banks' advances and investments. Although seemingly giving the Bank powers only to regulate specific types of advances or transactions which it might determine in its discretion, the Bank could, in terms of section 21(1) of the Act, also impose a ceiling on the overall ratio of banks' advances to deposits. The Bank's power in the latter regard was never tested in practice but officials felt its use was beset with difficulties, in particular that a ceiling on advances would offend the freedom of banks to deploy their assets between advances and investments. Besides, a lowering of the ceiling might create a scramble for government securities and offset to some extent the contractionary effect of the lower ceiling unless the Bank itself began selling securities to

interested commercial banks. A raising of the ratio, on the other hand, would work only when a ready market was available for the securities which banks wished to offload, and might perhaps oblige the Bank to undertake open-market operations once again. In practical terms, therefore, the Bank's untested power to regulate the advances-to-deposit ratio of banks under section 21(1) of the Banking Companies Act might merely duplicate its existing powers to conduct open-market operations and give the Bank little *additional* power to control credit. In contrast, control over required *cash* reserves would affect the banks' *'total power'* to extend credit without interfering with their freedom of portfolio choice.

Hence, from the Bank's point of view, section 42 of the Reserve Bank Act offered the more promising possibility of acquiring an additional instrument, which was both handy and flexible, to control the expansion of bank credit. Before this possibility could be realized however, the Reserve Bank of India Act itself had to be amended since in its present form the Act gave the Bank no power to vary commercial banks' reserve requirements.

In the past too, the Bank had made attempts to acquire similar powers, but these had come to nought. In 1948 its efforts were overtaken by events. The Bank's Department of Research and Statistics revived the proposal the following year when, in the course of a general review of the Reserve Bank of India Act, it proposed an amendment empowering the Bank to vary minimum reserve requirements between five and twenty per cent in the case of demand liabilities and two and eight per cent in the case of time liabilities. During consultations, the government, while not being averse to the amendment in principle, advised the Bank against pressing for it so soon after the Select Committee on the Banking Companies Bill had rejected a similar proposal. In the event the question of pressing the amendment did not arise as the Bank's Central Board, for reasons which were not recorded for posterity, overturned its own Committee's recommendation and threw out the proposal. Against this background the Finance Ministry's proposal to change the basis of note issue, requiring as it did legislative approval to come into effect, lent a new sense of focus and urgency to the Bank's ongoing review of its powers to regulate credit expansion by commercial banks. But taking the power to vary reserve requirements while changes were being made to rules governing the note issue was not merely a practical convenience nor a happy coincidence. On the contrary, officials within the Bank recognized that a simultaneous move on the two fronts would accurately reflect the changing nature of monetary control in a growing economy characterized by large debt or deficit-financed public expenditures, with the quantum of bank credit especially to the private sector likely in due course to become relative to currency, an

increasingly important target of monetary policy. Therefore, in the Bank's view, a pair of amendments which had together the effect of exchanging the less relevant tool of monetary control, which in any case was no longer practical, for a more realistic and contemporary one would underline this shift to the advantage of the Bank and the government.

The tone of the Bank's arguments for a more flexible system of reserve requirements was set in a lengthy note by S.L.N. Simha and a shorter one by B.K. Madan. Part of the argument rested on the limitations of the other general instruments of credit control, viz. the Bank rate and open-market operations, especially in underdeveloped money markets. Where their deposits were rising rapidly under the impact of deficit financing and commercial banks did not need to approach the central bank for accommodation, the Bank rate would only be an indirect deterrent whose effect depended on how sharply it was hiked. Besides, the Bank rate had repercussions beyond the sphere of bank credit, for example on government borrowing, which the monetary authorities might independently like to avoid. In the absence of an articulate and broad-based market for government securities, the scope for open-market operations as a tool of monetary policy was also relatively limited. Given the narrowness of the market, even limited Bank intervention carried the risk of triggering disruptive price changes which might militate against maintaining orderly conditions in the market and increasing the appeal of government securities. Little would be gained, for instance, should the resources soaked up through open-market operations be reinjected into the economy through additional Bank lending to the government to meet its resources gap. In addition, no means were yet available to compel banks to buy government securities in the desired quantities. The most effective step open to the Bank, in such circumstances, was the defensive one, which it had been adopting since 1951, of refraining from making net *purchases* of securities. On the other hand, by a mere 'stroke of [the] pen', a variation in reserve requirements would produce 'instantaneous effects' upon the banks' ability to create credit. This instrument would be particularly effective in India since a majority of the banks operating here preferred not to hold reserves much in excess of the statutory requirements.

A system with variable reserve requirements did present some disadvantages. For one, it might create some uncertainty for the banks, especially if reserves were frequently varied. Besides, it would affect all banks without regard to the quality of their loan portfolios from the point of view of the needs of the community. While this drawback was common to all general instruments of credit control, it was however possible to implement a system of flexible

reserves, as several countries were already doing, with an eye to features such as the size of banks and their location, Simha argued.

These general arguments in favour of the Bank acquiring the power to regulate commercial banks' reserve requirements were reinforced in the particular context of the Indian economy at the time. Bank credit to the private sector was beginning to boom, the increase in 1955–56 alone being larger than the total bank credit extended to this segment during the preceding four years. Although the second five-year plan had yet to be adopted, enough was known about it to suggest that the planned public sector deficit would be of the order of Rs 1,200 crores. Simha, as others within the Bank at the time, did not believe a change in the ratio of currency to money supply very likely in the near future and expected the increase in the Bank's credit to the government taking the form very largely of currency. Demand deposits, he felt, were unlikely to register an increase of more than Rs 400 crores or a third of the anticipated public sector deficit during the plan; and since little scope existed for multiple credit expansion, the total expansion of bank credit during the second plan period was also likely to be of a similar magnitude. While there would be no fear of runaway inflation if only this scenario was realized, the actual extent of deficit financing might be much larger than planned. Nor could the likelihood of 'unhealthy credit inflation' be accurately visualized at every stage. Should such inflation materialize, Simha argued, the success of the development programme itself could be at stake. Therefore, it was 'prudent to have as many reserve powers at our disposal as possible' so that if necessary, action might be taken 'on a variety of fronts simultaneously'.

The Bank's internal notes also emphasized that while monetary policy was generally more effective as a deterrent, the ability of the central bank to stimulate the economy through appropriate forms of intervention should not entirely be overlooked. Recent events following the end of the Korean boom showed that a flexible monetary policy could yield 'surprisingly good results ... in ... toning up' a sluggish economy. Here too, the power to alter banks' reserve requirements, in this case the power to release banks' reserves, would prove useful to the Bank. 'Fixed reserves may be alright in a static economy, but a dynamic economy requires a variable system.' Broadly endorsing Simha's arguments, B.K. Madan remarked on the advantages of deploying general credit control instruments in an integrated way:

a combination of a small increase in the ratio of required reserves with a small rise in the Bank Rate and a small decline in security values might yield more effective results than a larger increase in the Bank Rate with no increase in required reserves.

At Governor Rama Rau's instance, the Bank's Department of Banking Operations examined the proposed move and came to the opposite conclusion. It reasoned that reserve requirements in India were already quite high and that should it wish to, the Bank could use its powers under the Banking Companies Act to curtail advances. The department also drew attention to the danger of banks implementing enhanced reserve requirements by reducing their holdings of government securities.

Internal differences notwithstanding, the Bank resolved to acquire powers to regulate banks' reserve requirements as necessary. In its final form the Bank's proposal envisaged varying these requirements between 5 per cent and 20 per cent of banks' demand liabilities and 2 and 8 per cent of their time liabilities. In order to make the instrument more elastic and flexible in application, the Bank also sought the power to impose reserve requirements of up to 100 per cent in respect of banks' additional deposits, subject only to the overall reserve limitation for the two deposit categories. Since banks incurred a cost, in the shape of interest charges, on their deposits, the Bank favoured paying commercial banks 'moderate compensation' at a rate it would be free to determine on the additional reserves impounded in excess of the statutory minimum.

The Bank's proposals aroused some opposition from the business and the banking communities. The Federation of Indian Chambers of Commerce and Industry (FICCI) argued they were unnecessary, since the government had repeatedly voiced its intentions to keep deficit financing within manageable limits. The new measures would also discriminate against the more enterprising banks which succeeded in mobilizing larger deposits. Questions were also raised about the interest rate which the Bank would pay on the additional reserves, and fears expressed that higher reserve requirements would immobilize banks' working capital and affect their earnings adversely. The FICCI demanded that if the measure was judged to be absolutely essential, the Bank's powers to vary reserves should be limited to twice the minimum requirement. The Indian Banks' Association (IBA) also took exception to the new proposals. It protested against vesting in the Bank additional powers whose need was not dictated by past experience. Indian banks had amicable relations with the central monetary authorities and had cooperated fully with the latter's recent directive (May 1956) to reduce advances on paddy and rice. So far there had been no occasion when past conventions and practices had failed to yield the intended results. The new powers proposed to be given to the Bank, the association argued, could have serious repercussions on the monetary and credit structure of the economy. Banks' profitability would suffer and they would be obliged to transfer some of the additional costs to

their customers in the form of higher charges. If enhanced reserve requirements were thought to be unavoidable, it suggested, they should be imposed only in respect of additional deposits, and the Bank should be required to pay interest at the Bank rate on such reserves.

Both when the bill was in draft and in the course of its public airing, the government was generally supportive of the Bank's efforts to arm itself with additional authority to restrict commercial banks' capacity to expand credit. However, it sought for its own clarification more details on how the proposed measure differed from or reinforced the existing powers of the Bank to regulate commercial banks' advances under the Banking Companies Act. The government also had reservations about the overall limit which at 20 per cent was felt to be too high, and proposed for the Bank's consideration a lower ceiling of 15 per cent. In response the Bank argued that any figure for the ceiling would be arbitrary and that there was a strong case, from the point of view of perfect flexibility, for not prescribing a ceiling and leaving the ratio to be fixed entirely at the Bank's discretion. However, the range had been prescribed to disarm possible criticism and a further reduction in the ceiling would diminish the Bank's power to control credit. Following the Bank's reply the government took public criticism in its stride and the Bank's proposals to amend section 42 of the Reserve Bank of India Act were incorporated in the bill without much change. For all the controversy it had generated earlier, this amendment too evoked relatively little debate in Parliament. Passed into law in October 1956, the new powers were deployed briefly, and unsuccessfully as we will have occasion to observe in the next chapter, in 1960, any systematic recourse to them having to await the inflationary developments of the early 1970s. In the meantime, in 1962, the practice of setting different reserve ratios for demand and time liabilities was done away with and the Bank given the power to vary the unified ratio between 3 per cent and 15 per cent of scheduled banks' demand and time liabilities. At the same time the liquidity provisions of the Banking Companies Act were amended and rechristened with unconscious irony as the Statutory Liquidity Ratio (SLR). As part of this reform the cash reserve requirements under the Reserve Bank of India Act were separated from the liquidity provisions of the Banking Companies Act, so that banks could no longer count their minimum cash reserves towards their liquidity reserves. As discussed in chapter 11, these changes were intended principally to bolster banks' liquid resources which had been declining as a proportion of their deposits since the mid-fifties. But once in place the ratio was varied by executive order to restrict banks' ability to lend to the private sector and siphon their resources into lending to the government sector. As discussed in chapter 4, soon after the new statutory liquidity requirements

came into effect in September 1964, the Bank also introduced the concept of a net liquidity ratio to regulate commercial banks' borrowings from it. This new concept and the accommodation regime based upon it compounded the effect of the new statutory liquidity ratio on banks' portfolio decisions inasmuch as they were now forced in effect to choose between increasing their investments in government securities (despite the increasingly unattractive returns these offered) or paying more on their borrowings from the Bank.

Meanwhile, as elaborated in the next chapter, the Bank took increasing recourse during these years to selective credit control measures. A beginning was also made from the early sixties to direct the flow of bank credit to certain preferred sectors of the economy such as defence industries, exports, small industries, collieries, and agriculture. Together with the succession of seemingly unconnected and minor changes in rules and practices governing central government cash balances, state governments' working balances and overdrafts, and the reserve and liquidity requirements of the banking system, these developments had the cumulative effect of gearing the country's monetary and credit system first towards accommodating and then towards meeting the financial needs of a resource-hungry public sector, and dealing residually with the credit needs of those segments of trade and industry that lay outside the preferred sectors. Innovative as the Bank was in its efforts to implement these evolving priorities, they had some altogether unintended consequences for government finances, the health of the banking system, and for private trade and industry. The Bank saw these dangers clearly enough at various times. But they were by no means judged to be inevitable, more so since many of the policies adopted in the 1950s and 1960s were regarded, even as late as the mid-sixties, as temporary and reversible expedients. Besides, the incremental nature of the changes that overcame the monetary and credit system during these years perhaps blurred, to some extent, the Bank's vision of the larger emerging picture: that even by the mid-sixties its credit policies were threatening to become on the one hand exercises in the 'physical' allocation of bank funds between the government and the private sector, and on the other exercises in the rationing of these resources across competing claimants, some of whom were preferred and others were not, from within the private sector.

Once the picture cleared however, it became apparent that it blended quite well with the emerging intellectual environment which now generally favoured discretionary methods of intervention in several spheres of the economy. Though some officials within the institution voiced their doubts and Bhattacharyya himself remained sceptical, the Bank too, was not altogether immune to the influences of this environment. Indeed, far from being defensive

about their subordination of general instruments of regulation to sectoral or selective ones, by the end of our period or shortly afterwards, senior officials at the Bank began actively to champion departures from inherited doctrines of monetary policy to better meet the development needs of a planned economy. Ineluctably, perhaps, this advocacy soon extended beyond the comparatively narrow confines of monetary policy or sectoral credit flows, to focus on the ownership and organization of the banking system. The latter issues, however, lie beyond the scope of these chapters and the present volume of the Bank's history.