

## Monetary Policy, 1951–61

The 1950s were years of substantial price fluctuations in India. The outbreak of the Korean war in June 1950 sparked off inflation worldwide, and India was no exception. The general index of Indian wholesale prices (base 1939=100) rose from the pre-Korean war level in June 1950 of 397.1 to 449.6 by the end of March 1951. Although a sharp break in commodity prices followed thereafter, particularly from June onwards, traders continued to take a bullish view of the future. This was reflected in the credit situation. Scheduled banks expanded credit by Rs 182 crores during the 1950–51 busy season, but the ensuing slack season witnessed a return of funds to the tune of only about Rs 86 crores. As a result, the seasonal low in the level of outstanding advances at the end of the slack season was about Rs 95 crores higher than the corresponding figure at the end of the preceding slack season. This, to the Bank, represented a clear sign that bank credit was being used to finance speculative stockholding. The first five-year plan which was then getting under way heightened the Bank's concern about latent inflation and the resulting distortion in the allocation of resources it might cause. The balance of payments deficit, widening since the second quarter of 1951, was another worrying factor. Further, with the arrival of the busy season, the demand for credit remained strong and banks sought to augment resources by reducing their holdings of gilt-edged securities. The policy of supporting the latter's prices through appropriate intervention was an essential ingredient of the cheap money policy adopted for many years. But thanks to the rising demand for bank credit, the Bank's open-market purchases which had averaged about Rs 86 crores annually in the preceding quinquennium, rose steeply to Rs 155 crores in 1950–51.

## THE FIRST PLAN, 1951-56

The Bank believed, on the whole, that its support to the gilt-edged market had been 'discriminating and qualified'. But it led, in the words of P.S. Narayan Prasad who was the Bank's Economic Adviser at the time, to an 'exchange' of 'liquid money for securities', 'provided a basis for the expansion of credit by commercial banks', and caused the monetization of the public debt. Inflation could not be tackled, Narayan Prasad argued in October 1951, unless the 'net additions to money supply arising from the Reserve Bank's support of the securities market and ... the structure of yield rates which calls for such support' were eliminated. But a rise in the yields on government securities unaccompanied by a rise in the Bank rate might lead to banks expanding credit by borrowing from the Reserve Bank. Therefore it was necessary to 'apply restraint at both points', and raise the Bank rate too by half a percentage point from the prevailing 3 per cent.

## THE NEW MONETARY POLICY

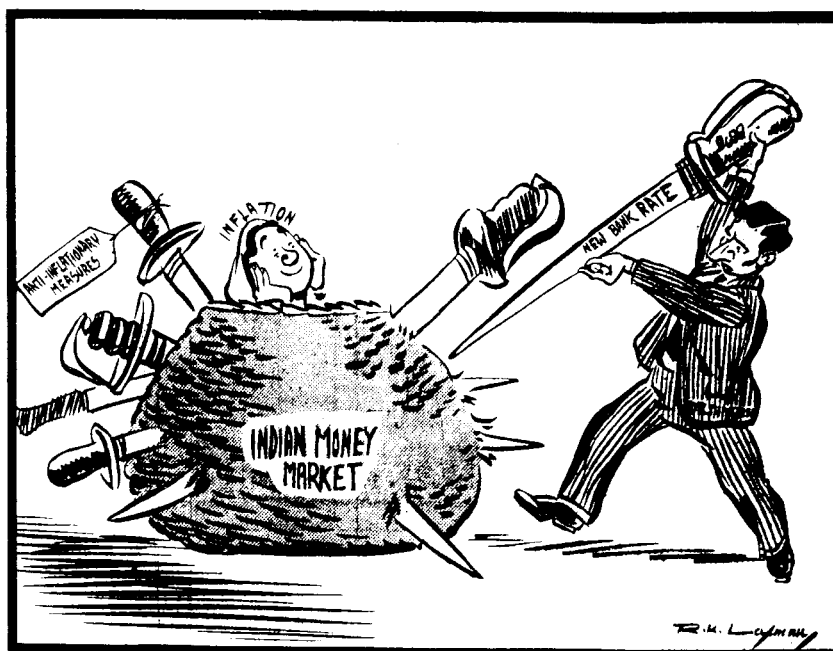
Prasad's 46-page memorandum came at a fairly advanced stage in the Bank's deliberations on an appropriate monetary response to the situation prevailing in the autumn of 1951. The Bank had been considering a move at least since August 1951 when the Governor, B. Rama Rau, resolved in consultation with the Finance Minister, C.D. Deshmukh, that an increase in the Bank rate, possibly by half a percentage point, had become unavoidable. The formal decision was however postponed until the middle of October. But with the busy season getting off to a sluggish start the decision was further put off to the middle of November. Finally on 15 November 1951 the Bank put up its lending rate to 3.5 per cent. At the same time it also decided, 'save in exceptional cases', to discontinue purchases of government securities from scheduled banks during the rest of the busy season.

These decisions marked an important departure from the Bank's earlier stance. Since November 1935, when the Reserve Bank of India itself had only been in existence for a few months, the Bank rate had stayed, seemingly unshakeably at 3 per cent which soon became a symbol of 'cheap money'. This rate, if not the underlying policy, had endured many political and economic vicissitudes, and more than one Finance Minister who wished for one reason or the other to see it changed. In the absence of an active bill market the Bank rate was the interest rate the Reserve Bank charged on its advances to scheduled banks. Until the early 1950s the Imperial Bank of India too, was a major source of accommodation for scheduled banks, and the Reserve Bank's rate was of relatively little practical use as an instrument of monetary policy so



Benegal Rama Rau, Governor, 1949–57

long as the former's call rate on advances was the lower of the two. The last few busy seasons had witnessed a gradual hardening of credit. The Imperial Bank's *hundi* (indigenous bill) rate, stationary at 3 per cent since November 1935, was raised to 3.5 per cent in January 1949 and to 4 per cent in January 1951. During the 1950–51 busy season the Imperial Bank also raised its call rate for advances of Rs 5 lakhs or more to scheduled banks against government securities from 2.75 per cent to 3 per cent, and that on loans below Rs 5 lakhs from 3 to 3.25 per cent. The major bazaar bill rates and the rates charged by exchange banks on overdrafts too, had been nudging upwards since the last two busy seasons. The general hardening of the Imperial Bank of India's lending rates encouraged banks to approach the Reserve Bank for accommodation and helped revive the Bank rate from its earlier dormant state. But as we saw above, the Bank apprehended excessive credit expansion should its rate became operative at 3 per cent, and felt justified in putting it up by half a point. Although inevitably in this instance, the Reserve Bank of India followed the market rather than led it and the hike in the Bank rate was intended to bring the latter in line with the changes that had already taken place in the interest rate structure, the Imperial Bank responded by raising its discount rate for *hundis* from 4 to 4.5 per cent and its general rate on advances

*INVULNERABLE*

- *Tol*, 18 Nov. 1951

to 4 per cent. Other scheduled banks also raised their deposit and lending rates by up to half a percentage point. The November 1951 decision thus marked the end of a lengthy period during which the Bank followed a passive interest rate policy, if not yet the inauguration of a more active one. The Bank rate stayed at 3.5 per cent until 1957 and was put up successively until 1965 when it reached 6 per cent, before being lowered to 5 per cent in March 1968.

The decision to 'refrain' from buying government securities was also a major departure from past practice, not to mention a significant aberration in the light of later developments, since for the moment at least, Bank policy was not dominated by the need to protect the market for government borrowing to the exclusion or neglect of other objectives. This move, which was signalled somewhat unusually through a press communique whose draft Rama Rau wrote in his own hand, was made in consultation with the government. Besides being essential for the success of the policy of dearer money, it was also justified on its own merits. The persistence of inflationary expectations in India and the lifting of some wartime import controls boosted the demand for

credit to finance stockholding and imports. Although the option of borrowing against government paper was always open to them, increasingly commercial banks preferred to augment their liquid resources by selling government securities. The Bank viewed this trend with growing disapproval since it led to monetizing the public debt and involuntary additions to base money in the midst of inflationary pressures.

The Bank's new open-market policy undoubtedly gave teeth to the Bank rate. With the closing of the repurchase window, the Bank's advances to commercial banks against government securities spurted from Rs 20 crores in 1949–50 and Rs 48 crores in 1950–51, to Rs 167 crores in 1951–52. But the Bank was not inclined to worry. The increase was only to be expected. Besides, the Bank judged that this mechanism was more likely than the one it had displaced to promote a reverse flow of funds during the slack season. In the event, seasonal advances to scheduled banks outstanding at the end of June 1952 amounted to only about Rs 1.68 crores. Greater elasticity in the seasonal expansion and contraction of credit was also an objective of the bill market scheme which, as discussed below, was instituted within weeks of the new monetary policy. Finally, the greater reliance banks placed on advances from it, the Bank hoped, would promote more frequent contacts with them and conduce to 'better mutual understanding ... in the context of the responsibilities placed on the banking system in the Five Year Plan'.

More immediately, however, the new policy on open-market operations depressed prices in the gilt-edged market. The trend in the latter market had been downward for almost a year, with the Bank supporting 3 per cent long-dated paper since December 1950. The Bank, according to the Deputy Governor, N. Sundaresan's weekly letter to the Finance Ministry written a couple of days after the new monetary policy was announced, remained in the market till as late as two-thirty in the afternoon of 14 November 'in order not to give any indication of an impending change' of policy. With the result, the market 'felt completely stunned' when the new policy was announced. Although trading was nominal when markets opened the following day, prices fell quite sharply. The decline was most pronounced in the case of long-dated and non-terminable securities, the pivotal 3 per cent 1986 Conversion Loan, quoted since 17 September at the support price of Rs 92-11, dropping to Rs 87-8 on 15 November. Yields on gilt-edged paper of various maturities tended to get dispersed as trading remained nervous and speculative for a few days; while the spread between these yields and those on other securities such as company debentures narrowed. In an effort to calm a skittish market the Bank issued another press communique on 20 November carrying a summary of the Governor's interview that day with bankers in Calcutta during which he was

reported to have declared that the Bank was 'responsible for the maintenance of the financial credit' of the government and that 'if the circumstances justified such a course' it would 'take appropriate measures to maintain government credit'. This statement managed to offend the Finance Minister who took a dim view of the Bank's perception of its own role in safeguarding the government's credit, but did little to reassure the markets. Although sentiments remained unshakeably bearish especially in Calcutta, the Bank appears to have felt in the absence of 'transactions of any magnitude' that the market quotations were largely nominal. According to Rama Rau, 'whenever there was an enquiry for the investment of a fairly large sum ... the prices quoted are much higher than the nominal market value'. 'Speculative activity', he argued, had brought about the fall in market quotations and 'no two brokers agreed on all the quotations'.

This brave front soon began to give way, however. Towards the end of November 1951 some 'peevisish' traders in Calcutta sold small quantities of the 1986 loan at Rs 80-14 when the Bombay quotation was Rs 82-8. Subsequently the market appeared to be steady at Rs 80-12, with the Bank still preferring to wait upon events. But on 3 December a Calcutta broker, 'whether out of mischief or ignorance', sold the paper at Rs 79-6. Fearing any further fall to have 'very serious repercussions', the Bank decided in consultation with the government to resume support to the 1986 loan at Rs 80.

The new measures were not free from public controversy either. The announcement of Mint Road's decision to stand aside from the market raised many eyebrows, some commentators observing that it marked a departure from the central bank's tradition of secrecy with respect to the affairs of its most important customer, and that a less publicized (and 'amateurish') withdrawal may have cushioned the fall in gilt-edged prices. The latter's steep decline also provoked criticism. Accusing the Bank of being 'nobly absorbed' in pursuing 'orthodox principles of finance', a financial paper charged it with indifference to securities shedding 'a few hundred millions or a few hundred crores' and inflicting capital losses on commercial banks and insurance companies holding large volumes of these assets. In the event, responding to representations from bankers who apprehended the impact on public opinion of lower dividends and the publication of balance sheets showing losses on their investments, the Bank advised the government to exempt banks from the legal requirement of having to show in their balance sheets and accounts the market value of their investments on the last day of 1951, and to waive the application of sections 15 and 17 of the Banking Companies Act. The section 15 waiver enabled banks to pay dividends without writing off the depreciation

in the value of their investments in approved securities so long as they did not capitalize the depreciation or account for it as a loss. The original section 17 of the Banking Companies Act was thought to prevent banks from making appropriations from reserves to write off losses on their investments until the former equalled or exceeded their paid-up capital. This provision too was relaxed through an executive order to enable banks to write off the depreciation if they chose to do so.

The revival of the Bank rate as an effective tool of monetary policy, after a long interval during which it had had little bearing on the level and structure of interest rates in the market, was generally welcomed. But some critics saw the decision, which came a week after the Bank of England put up its discount rate, as a sign of the latter's tutelage over the younger central bank.

Anticipating the criticism that it was following blindly in the footsteps of the Bank of England, the press communique announcing the change in its lending rate (which too was drafted by the Governor) disclosed that the Bank and the government had arrived at this decision as early as August. This statement too failed in its intended purpose, and merely led to suggestions in some sections of the press that members of the Committee of the Central Board were aware of the impending change even in August. The actions of a Bombay trader who sold large stocks of gilt-edged paper for an eventual profit of about Rs 5 lakhs also fuelled rumours of a leak.

For its part, the Bank issued a statement asserting that no advance notice of its rate increase was given even to its Directors. This statement too, failed to please, one paper deriding it as an 'unwarranted "apologia"' because the 'very fact that the market was shocked by the suddenness of the Bank's decision' offered abundant proof that 'there was no leakage of information'.

#### THE BILL MARKET SCHEME

Although instituted as an afterthought in January 1952, the bill market scheme has since come to be regarded as an ingredient of the new monetary policy inaugurated in November 1951. The scheme aimed to provide eligible banks a mechanism they could use to obtain advances from the Bank against specially created bills of a self-liquidating character. Advances under the scheme were granted under section 17(4)(c) of the Bank Act against bills satisfying section 17(2)(a) of the same Act, i.e. those arising out of bona fide commercial or trade transactions, having a maturity not exceeding ninety days, and bearing two or more good signatures including one of a scheduled bank. To avail of advances under the scheme, eligible scheduled banks were required to convert their borrowers' demand promissory notes into usance promissory notes

maturing within ninety days and lodge them with the Bank as collateral. They were also free, generally, to withdraw any of these bills or to replace them with other eligible bills. The scheme, according to its promoters, thus combined 'the advantages of the cash credit system with those of the bill of exchange'. Advances under it were originally made at one half of one per cent below the Bank rate, with the Bank also agreeing to meet half the stamp duty charges on eligible usance bills. As introduced in January 1952, the scheme was confined to scheduled banks having deposits of Rs 10 crores or more. The minimum amount a bank could borrow at a time and the minimum value of each individual bill lodged as security were fixed at Rs 25 lakhs and Rs one lakh respectively. The first advance under the scheme was made in February 1952, yet by the middle of April that year limits aggregating to over Rs 44 crores had been sanctioned to eight eligible banks, six of whom availed of advances to the tune of over Rs 29 crores. Over the next few years the scheme was expanded to cover a larger number of banks, the minimum amount banks could borrow and the minimum value of each individual bill were both lowered, the usance period was increased to 180 days, and export bills were also brought under its purview. The Bank devoted serious thought at various times to bringing *hundis* under the scheme but refrained from doing so since not all *hundis* arose in the course of trade. Besides, it was difficult to ascertain reliably, the creditworthiness of borrowers issuing *hundis*.

As its name suggests, the new scheme was represented as a step towards creating a market for bills in India. But it also signalled the coming together of certain other objectives and considerations. The scheme was modelled principally on a practice prevalent in the 1920s and the early thirties to relieve seasonal stringency in the money market whereby the Currency Department of the Government of India (corresponding to the Issue Department of the Bank) made advances to the Imperial Bank against internal bills of exchange, *hundis*, and against bills the bank created out of advances it had made for the 'furtherance of trade'. At least twice earlier, during the 1947-48 busy season and again in July 1948, the then Governor, C.D. Deshmukh, considered reviving this practice which had fallen into disuse more than a decade earlier. However banks responded coldly to the idea, maintaining that the existing provisions of the Bank Act were 'sufficient to meet the normal or seasonal requirements of banks' for funds, and that the real need was to give the Bank more powers to make advances to scheduled and non-scheduled banks in an emergency. The Bank then concluded that no special measures were needed to relieve the market during the peak season.

In 1951-52 however, the decision to institute the bill market scheme by adapting the earlier precedent was taken and implemented in record time.



The initiative for the scheme came from the very top, Rama Rau appearing to have decided to seize the opportunity presented by the new monetary regime to put in place a supplementary system of advances that would enable the Bank to 'follow the utilization of the funds' it advanced to commercial banks. Hence a little more than a week after the new monetary policy was unveiled, the Governor held discussions with Roderick Chisholm, the Managing Director of the Imperial Bank of India, about 'the development of a bill market in India or, in the alternative, expansion of currency for seasonal requirements' against bills of exchange 'manufactured' by converting demand promissory notes of borrowers into usance bills. Rama Rau's earliest discussions with Chisholm on this subject took place on 23 November. Three days later Chisholm sent the Bank some papers dealing with interwar arrangements to relieve monetary stringency in the peak season. The same day officials at the Bank went to work, examining the possibility of adapting the historical practice to current requirements. The Department of Banking Operations' sceptical note on the subject was finalized on 29 November. Disregarding departmental reservations, the Governor passed his orders the following day asking for a draft scheme to be prepared for circulation and discussion. This was done within the next four days. There was some delay at this stage, bankers consulted about the proposals taking nearly a month to react. But by 12 January 1952 the Committee of the Central Board had approved the scheme and the circular announcing it was issued four days later.

The speed with which the bill market scheme was prepared and adopted should not be allowed to obscure the mixed feelings officials within the Bank entertained about it. The idea of reviving the interwar procedure to relieve peak season stringency did not fill the Department of Banking Operations with enthusiasm. A note by T.V. Datar, its Chief Officer, recalled the many difficulties the Bank had earlier apprehended would arise in working a scheme that depended largely on converting demand notes into time notes. Constituents might resist such conversions not least because of the stamp duty liability involved and were likely, in any case, to be unfamiliar with the requirements they would have to satisfy before their banks could take advantage of the facility. Ascertaining the financial standing of borrowers did not present major problems in the earlier arrangement which was confined to the Imperial Bank. Any similar scheme implemented now would have to include other banks. But an expanded scheme, Datar warned, would mean delaying approvals of individual limits for banks' constituents until the Bank had had an opportunity to satisfy itself about their standing. The alternative of accepting banks' certificates regarding the creditworthiness of their borrowers was full of risk. Datar also wondered whether as a 'measure of long-term policy', the Bank

should not seriously reconsider its support to 'banks even for seasonal requirements'. Deposits of banks

are fairly stable, while ... advances are rising year after year .... If the liquidity of the banking system is to be maintained, it would perhaps be worthwhile urging the banks to make a concerted drive to reduce their normal commitments so that their recourse to the Reserve Bank during the busy season would not strain their liquidity to ... breaking point.

If legal and practical difficulties were overcome and it was decided to institute the new system of advances, Datar cautioned, it would be necessary

to confine it to a few large and sound banks which may be relied upon to hold ... bills in their custody on behalf of the Reserve Bank, to hand over to us a certificate of the bills held along with their promissory notes, and to pass on the proceeds to us when the bills are realized.

In drawing attention to the liquidity aspect of banks' seasonal operations Datar anticipated an important consideration underlying the adoption more than a decade later of an accommodation regime based on banks' net liquidity ratios (or NLRs). But neither his reservations nor those of the Legal Department, which raised a number of largely procedural objections, cut much ice with Rama Rau whose response to Datar's note was to direct his department '*urgently*' to draw up 'details of a practical scheme' for discussion at the next meeting of the Central Board (emphasis in the original). The rest is history.

The bill market scheme was accorded a favourable, even rapturous welcome by a market that had grown distinctly nervous about the impact of the Bank's new monetary policy. According to *Indian Finance*, Rama Rau had shown the 'correct insight into the needs of monetary institutions' affected by the new monetary policy. Six weeks later when the Bank announced having made advances totalling Rs 11 crores to banks against usance bills, *Indian Finance* was ecstatic. The scheme represented the 'first planned steps for a bill market' and from this point of view, the journal remarked with not a little exaggeration, its commencement would remain a 'memorable' event 'in the annals of the Indian money market'.

It is clear however in retrospect that much of the enthusiasm for the bill market scheme was misplaced. Though the scheme purported to pave the way for a bill market in a system dominated by loans, cash credits, and overdrafts,

it became merely a supplementary means of replenishing banks' resources. There were a number of reasons for this outcome, but chiefly the scheme itself was a flawed one in significant respects. Even if it was realistic to expect banks and their constituents to graduate over time from bills 'manufactured' by converting cash credit to genuine trade bills, the 1952 scheme created little incentive for them to do so. Consider here the provision for lodging bills as collateral, or the practice of sanctioning credit limits to banks' constituents qualifying for advances under the scheme and allowing the former to replace maturing bills with new ones. Clearly, neither feature was calculated to enhance the prospects of a bill market coming into existence in India. On the demand side too, many constituents of banks were nervous about the scrutiny their borrowing under the scheme attracted from the Bank. In the beginning, particularly, scrutiny sat lightly upon borrowers. Rejection rates were low, and early in the life of the scheme the Bank decided banks should not force their clients to submit balance sheets since doing so would 'add to the difficulties experienced ... in persuading [them] ... to convert advances into bills ... and hamper the working of the scheme'. Scrutinies became somewhat less cursory in subsequent years, but even as late as July 1955 a decision by the Bank's officers to reject an application from the Punjab National Bank for a 'bill market' credit limit to be made available to a Kanpur trader evoked fierce debate within the Bank; with Rama Rau, who took a great personal interest in the working of the scheme and who asked to be consulted about all decisions to reduce or reject limits, expressing astonishment that the Bank should turn down the proposal 'merely because ... he [i.e. the client of the bank] is interested in purchasing silver bars on behalf of speculators'. In the end Rama Rau yielded to the judgement of his subordinates, but in general too, from the second half of the 1950s, the Bank became more sensitive to the 'quality' of the credit supported by usance bills presented by banks. As a consequence, banks and their constituents grew more wary of approaching the Bank for accommodation under the scheme.

To some extent the bill market scheme was undermined during Rama Rau's own tenure as Governor by the government's decision to increase the stamp duty on bills. The details of this particular controversy and its fallout, in the form of Rama Rau's resignation as the Governor of the Bank in January 1957, are related in a later chapter. Suffice it for the present to point out that at the end of November 1956 the government mooted proposals to raise the stamp duty on usance bills forty-fold from two annas per Rs 1,000 to Rs five (or 80 annas). Early in 1956 the Bank had felt emboldened enough by the success of the bill market scheme to reduce or withdraw the concessions

extended to advances under the scheme. From November 1956 advances under the bill market scheme too, were charged interest at the Bank rate of 3.5 per cent. But the cost of borrowing under the scheme exceeded the Bank rate by the extent of the stamp duty on the usance bills created by the borrowing bank, with the State Bank of India, for example, calculating in December 1956 that the effective cost to it of funds under the bill market scheme exceeded the Bank rate by 0.39 per cent even at the lower stamp duty rates then prevailing. The steep increase in the stamp duty the government now proposed threatened to extinguish the bill market scheme altogether since the effective cost of borrowing under it was expected to exceed 4 per cent per annum, while banks could avail of loans against government securities at the Bank rate of 3.5 per cent.<sup>1</sup> However, more than the government decision which led to it, Rama Rau's exit represented the more permanent setback for the bill market scheme. Advances under the scheme peaked at Rs 560.6 crores during the 1956-57 busy season. But thanks both to demand-side factors and to the Bank beginning to view accommodation under the scheme with a certain amount of disfavour, advances slumped sharply in each of the next three years to bottom out at Rs 85.4 crores in 1959-60. The bill market scheme however continued for several years more during which it was also expanded to include export bills with maturities of up to six months. Advances under it also rose in the mid-sixties from the low levels they had touched at the turn of the decade. But the scheme never quite recovered to the position of importance it had occupied in the Bank's priorities during the Rama Rau years.

Neither the government nor the change in the stewardship of the Bank can however be blamed for the scheme's lack of success. Even within the Bank there was a certain lack of clarity about the objects of the bill market scheme. As we saw earlier, Rama Rau's note of his discussions with Roderick Chisholm mentioned easing seasonal stringency in the same breath as creating a bill market. The early notes prepared by the Department of Banking Operations did not regard the scheme as a precursor to the creation of a genuine bill market but as an alternative to it. The scheme, according to the department, was thus a second-best solution which would enable the Bank to follow the utilization of the funds it advanced to banks and ensure their repayment at the end of ninety days. But in the event, as pointed out above, allowing banks to replace maturing bills with new ones meant there was no

<sup>1</sup> The effective cost of borrowing under the bill market scheme typically exceeded the Reserve Bank's lending rate plus the stamp duty, since banks did not always utilize their bill market limits in full.

automatic tendency for advances to be called in at the end of three months. Six months after the scheme was instituted, the Department of Banking Operations persisted in viewing it as a supplementary replenishment arrangement and proposed discontinuing accommodation under it for the duration of the slack season since banks' liquid resources had increased and interest rates in the money market were coming down. But Rama Rau rejected the suggestion. Arguing that 'the office' had not 'understood the objects of the scheme' which was 'designed to create a bill market in India as a permanent measure', he insisted that it must 'of course continue even during the slack season'.

As later events showed, the Department of Banking Operations' view of the arrangement was the more realistic one. Commercial banks, as a study group appointed by the Bank in 1970 on enlarging the use of the bill of exchange and creating a bill market remarked, used the scheme merely as a source of supplementary accommodation in the peak season on the basis 'of improvised bills'. Officials within the Bank had been aware of this for some time, but it was not until H.V.R. Iengar (who did not entirely share Rama Rau's enthusiasm for the bill market scheme) became Governor that the Bank began considering ways of encouraging commercial banks to use its facilities 'sparingly and exceptionally'. Borrowers too grew notably less enthusiastic about the scheme except during periods when their banks faced an acute shortage of liquid resources, more so after the Bank put up the cost of its accommodation and began paying greater attention to the quality of the credit extended under it. So even the severely curtailed credit limits made available to banks under the scheme often remained underutilized in later years.

The bill market scheme revived in popularity in the early sixties as commercial banks sought to use Reserve Bank finance to sustain high credit-deposit ratios without unduly impairing their liquidity position by borrowing against created bills rather than against government securities. So much so, that officials at the Bank began seeing the scheme as a symbol of the growing dependence of commercial banks on credit from the Reserve Bank which they now sought to reduce; and in August 1964 they briefly turned their thoughts, ironically enough, towards charging a higher rate of interest on the Bank's advances under the bill market scheme than that proposed to be charged on its advances against government securities, export bills, and 'genuine internal bills of exchange'. More generally, the change that overcame the Bank's attitude towards the scheme in the 1960s also mirrored its new concerns and priorities: it was now more closely involved than in the fifties in financing the government sector and preferred to see commercial banks expanding lending

to the private sector by augmenting their deposit resources rather than on the strength of loans from the Bank.

#### THE QUIET YEARS, 1953-56

A combination of domestic policy factors, an improved supply position thanks to higher production and imports, and favourable external developments together helped spike the Korean boom in India. Bank credit fell some 12 per cent in 1952 and the downward trend was sustained the following year as well, so that the credit-deposit ratio of banks fell from a high of nearly 65 per cent in 1951 to less than 57 per cent two years later. Over 1952-53 wholesale prices too, dropped by over 15 per cent in contrast to a rise of 5 per cent the previous year. The Bank had reason therefore to feel satisfied that its new monetary policy had helped create conditions conducive to the 'expansion of credit for bona fide transactions' while discouraging speculation financed by bank credit. Although it was only later that the concept was explicitly elaborated, the new monetary policy represented the first instance of the application of a policy which later came to be known as one of 'controlled expansion'.

In contrast to an eventful first half, the latter half of the first plan period was relatively uneventful and was on the whole marked by stability. Worries about inflation revived in the concluding year of the plan, but otherwise the Bank could afford to lower the profile of monetary policy during these years whilst ensuring that the productive needs of the economy were met without fuelling speculation. After declining from Rs 462 crores the previous year to Rs 443 crores in 1953-54, outstanding advances rose to Rs 468 crores in 1954-55 and further to Rs 514 crores in 1955-56. Accommodation under the bill market scheme was made easier too, by progressively extending its coverage to all licensed scheduled banks, reducing the minimum limit for advances and for individual bills, and the grant of stamp duty concessions. The underlying economic trends were largely favourable, with wholesale prices actually recording a net decline during these years. Open-market operations represented the only active component of monetary policy in this period, with the Bank effecting net sales of securities (of about Rs one crore) in 1952-53 for the first time since World War II. The next three years were also marked by net sales of government securities, of about Rs 22 crores in 1953-54, Rs 28 crores in 1954-55, and Rs 16 crores in 1955-56.

Money supply trends too varied considerably between the first two years of the first five-year plan, and the last three. During 1951-52 and 1952-53, money supply declined by nearly Rs 220 crores, the bulk of the fall taking

place in the first of these two years. The unusual phenomenon of an actual decline in money supply in an economy where substantial investments were taking place provoked discussion within the Bank and with the government. The principal reasons for this were the fall in the country's foreign exchange reserves to the tune of Rs 160 crores during these two years to support domestic consumption and investment, a sizeable surplus in government revenues, and the accrual to the latter of the domestic proceeds of the US wheat loan.

Both industrial and foodgrains output rose steadily through the early fifties. These, together with favourable developments on the fiscal, prices, and money supply fronts, encouraged the government to step up its development outlays halfway through the first plan. The plan's projected public sector outlay was increased by Rs 175 crores to Rs 2,244 crores in October 1953. Budgetary deficits expanded to finance this enhanced outlay. With bank credit to the private sector booming and exchange reserves showing some rise, money supply increased substantially by over Rs 421 crores in the last three years of the plan. The growth of money supply in the last year (1955-56) alone was of the order of over Rs 264 crores. This increase of about 14 per cent over the money supply figures of the previous year was both a worrying sign at the Bank and an early indication of the shape of things to come in the second plan. Prices were another ominous portent. The existing series (1939=100) showed that wholesale prices declined some 12 per cent in 1954-55, but rose the following year by nearly as much. These increases spilled over into the inaugural year of the second plan when prices rose by about 8 per cent.<sup>2</sup>

### THE SECOND PLAN, 1956-61

The latter half of the fifties presented a vastly more complicated environment for monetary policy than the first. These years coincided with the second plan, which was much more ambitious than its predecessor, involving a planned public sector investment outlay of Rs 4,800 crores of which a quarter was to be met through deficit financing. Commercial bank credit, the private sector's

<sup>2</sup>Until the late 1950s, the Bank relied on the wholesale prices (end of August) series cited here. This index was revised sometime towards the end of the decade. According to the new index (1952-53=100), average weekly prices fell by about seven per cent in 1954-55, dropped further by 5 per cent the following year, and rose by nearly 14 per cent in 1956-57. Needless to add, the revised index was not available to the Bank authorities until later in the decade.

demand for which increased as public sector investment translated into growth in aggregate demand, also showed a tendency to expand much faster during this period than in the earlier one. On the other hand, these years were marked by harvest shortfalls, a sharp fall in foreign exchange reserves due to large imports particularly of capital goods, and consequently by the imposition of controls on imports of many consumer and intermediate goods. The economy grew at a healthy rate of about 7 per cent per annum during two of the five years of the second plan period. But the overall picture was less impressive, real rates of growth aggregating to about 22 per cent during the entire period for a compound annual growth rate during the plan of just over 4 per cent. Thanks to high levels of deficit financing and despite the steep fall in foreign exchange reserves, money supply and wholesale prices rose by nearly a third. The large size of the second plan, the manner of financing it, the rapid expansion of bank credit to the private sector, and the multiple constraints which impinged on the plan and on the economy at large during these years called for a more activist monetary policy than at any time in the past history of the Bank. Hence the somewhat involved story of monetary policy during these years is also a story of the conflicting objectives which monetary policy had to reckon with if not always pursue, and the new instruments which the Bank began to deploy in an attempt to reconcile the objective of price stability within the broad context of deficit-financed growth envisaged by the country's planners.

The very first year of the second plan (1956–57) posed the kind of challenge to the Bank which it was to face at regular intervals during the next few years. Wholesale prices rose by 8 per cent (according to the old index which was all officials had to go by) over the previous year, even while markets showed signs of acute financial stringency. This stringency reflected the accelerated tempo of investment activity in the economy. But the resulting upward trend in money rates, call money rates, and the deposit and lending rates of commercial banks also threatened to put a brake on industrial expansion, with firms finding it increasingly difficult to raise resources. The Bank was inclined to regard this as characteristic of a phase in a boom during which the demand for investment outran the supply of savings in the economy, but was however loath to regard it as entirely a temporary phenomenon in a developing economy with a low underlying savings rate.

The situation eased in the next two years as there was a marked slow-down in industrial activity and in the rates of growth of bank credit and money supply. In 1959–60 however, both money supply and bank credit rose sharply, while commodity prices too appeared to be following in the wake of the quickened pace set towards the end of the previous financial year; moreover,



unlike in earlier years, the rise was largely in groups other than food articles. Money supply with the public increased by nearly 8 per cent during the year on top of a smaller increase of about 5 per cent in 1958–59. There was evidence too of unhealthy speculative activity in the share and commodity markets. Although the government's recourse to Bank credit declined in 1959–60 for the second successive year, the steep drop in foreign exchange reserves meant that these no longer provided a comfortable cushion against inflation. In brief, the dilemma facing the Bank for much of the second plan period was that though developmental expenditures were adding to inflationary pressures and boosting the demand for credit, it could not adopt a stringent credit policy without appearing to dampen productive investment. At the same time, the worsening external account prevented recourse to imports to curb inflation and created an environment in which speculative stockholding became an attractive bet. But as noted in the previous chapter, this dilemma was not one which, in the opinion of the Bank, monetary policy by itself could resolve.

#### CONTROVERSIES OVER CREDIT POLICY, 1956–57

As the first five-year plan drew to an end and the second got under way, the Bank was faced with the problem of acute financial stringency in the markets coexisting with considerable inflationary potential in the economy. The Bank was aware that easier credit would ease the stringency in the short term, but was also conscious of the risk of a liberal monetary policy fuelling speculation. During discussions with the government over policy during the 1956–57 busy season, the Bank's own preference was for maintaining a complementary restrictive policy stance in both the fiscal and monetary spheres alongside making special efforts to meet clearly identified credit needs which could be justified in the larger interest of the community. Not only was government policy more liberal than the Bank liked, the new Finance Minister, T.T. Krishnamachari, made little secret in public of his views on the policy stance the Bank preferred to adopt at the outset of the 1956–57 busy season, even making use of his meetings with bankers to signal a credit policy which was at variance with that of the Bank. Relations between the Bank and the government reached their nadir some weeks into this busy season. Although Rama Rau regarded Krishnamachari's decision to raise the stamp duty on bills as the major provocation, simmering differences over policy contributed greatly to the prickly relationship he shared with the Finance Minister during what turned out to be his final months in office.

A memorandum to the Central Board prepared in April 1957 describes with admirable clarity the approach which was advocated during the

past busy season and which H.V.R. Iengar, Rama Rau's successor as Governor, resumed canvassing with the government. According to this memorandum, while the Bank was aware of the need for expanding 'credit and money supply commensurate with the rapid development ... of the economy', relief

of financial stringency through *general* measures will assist inflation and may therefore prove self-defeating. In the present situation relief of financial stringency should rather be directed to the provision of credit for specific essential purposes while at the same time restraining excessive diversion of the limited supplies of credit for less essential, though more profitable and, therefore more attractive uses.

In common with other central banks, the Bank too was generally loath to rule out recourse to general instruments to manage demand in the economy. Besides, the Bank reasoned that 'the basic solution to the problem of stringency' lay in promoting savings, and higher interest rates had an important role to play in encouraging a larger volume of savings to flow into the banking system. Neither were officials unmindful of the advantages of selective credit controls. But not content merely to play a fire-fighting role, the Bank appears to have been quite keen during these months to keep the embers of inflation from breaking into flame.

The policy which the Bank adopted at the time was described as one of 'controlled expansion'. This, in the Bank's mind, signified a two-track policy of generally restraining demand in the economy while selectively easing credit. As a memorandum to the Committee of the Central Board put it, an appropriate monetary and credit policy had to use 'some combination of the two methods, and not either method to the exclusion of the other. It is this proper combination which we have continually to attempt to evolve.' But expansion preceded control by several months as a series of meetings Krishnamachari held with bankers and changes at the helm of the Reserve Bank culminated in credit policy being eased to meet busy season requirements. As part of this policy and in order to '[increase] the resources of the banking system and incidentally to lend support to the gilt-edged market', the Bank carried out open-market operations both in short-dated government securities and in long-dated and non-terminable paper. Commercial banks were also allowed to exceed their normal credit-deposit ratios, which in some cases touched nearly 85 per cent. As a result of the liberal policy, commercial banks' credit to the private sector rose by Rs 165 crores during 1956-57, a quantum of increase which was not exceeded until 1960-61.



H.V.R. Iengar, Governor, 1957-62

In the event, this policy could not be sustained. As we note in greater detail below, the Bank had begun selectively raising the cost of credit in some segments of the market even from November 1956. As wholesale prices rose nearly 14 per cent through 1956-57, the Bank reverted in July 1957 to the open-market stance it had adopted since November 1951 and up to October 1956. This reversal followed on the heels of an increase in the Bank rate from 3.5 per cent to 4 per cent on 16 May 1957. Alongside putting up the rate, the Bank also recommended a reduction in the stamp duty on usance bills from half a per cent to one-fifth of one per cent.

The long overdue increase in the Bank rate had been under contemplation for several weeks, and its precise timing was an outcome of discussions with the government which was understandably concerned about its impact on the market for its securities. The Bank's own preference was to raise the rate before the government entered the market with its loans rather than afterwards. The timing of the new monetary policy of 1951, which was announced after the central and state governments withdrew from the market upon completing their loan programmes for the year, was criticized by some who believed the Bank had broken faith with investors who bought these loans. The Bank did not wish to give room for similar criticism now and so preferred to have the

rate increase behind it when the government came into the market to gather its loans for the year. The government too, for its part, was convinced that a Bank rate increase was inevitable and that only its timing remained to be determined. But even here there were few options available. There was widespread agreement that the Bank rate increase could not be put off until the end of the slack season or even until July. Nor could the government hope to advance its loan programme and carry it out successfully in an atmosphere rife with expectations of a Bank rate increase. On the other hand, if a change in the Bank rate had to precede the government's loan programme it was necessary to allow a sufficient interval to elapse for the dust raised by the move to settle down. These considerations therefore pointed, in the Bank's view which Lengua persuaded the government to accept, to the necessity of putting up the Bank rate sooner rather than later.

The May 1957 increase in the Bank rate, according to the Governor's memorandum to the Committee of the Central Board, merely meant according 'formal recognition to a situation that has existed de facto for several weeks'. Earlier in March 1956, the Bank had put up the interest rate on lending under the bill market scheme from 3 per cent to 3.25 per cent. At the same time, the stamp duty concession previously allowed to 'bills' under this scheme was withdrawn. The lending rate was raised further to 3.5 per cent, which was the prevailing Bank rate, in November 1956. The latter translated into an effective lending rate under the scheme of more than 4 per cent when the government raised the stamp duty on usance bills shortly thereafter. The rate on advances against government and other approved securities was also raised from 3.5 to 4 per cent in February 1957 in order not to discourage the use of bills. Therefore, the decision of May 1957 was intended really to put a stamp on the interest rate changes already carried out by the Bank in some segments of the market for its credit, 'rationalize the lending rate structure of the Bank', and make the structure of its interest rates 'internally more coherent'. Raising the Bank rate had other advantages as well. For one, banks appear to have been reluctant to increase their lending rates without a formal increase in the Bank rate. Secondly, the Bank's loans to state governments and the Industrial Finance Corporation were made at the Bank rate. A low Bank rate which did not reflect the conditions of the market, officials at the Bank feared, would discourage these borrowers from approaching the market and offering 'appropriate rates for raising funds' and instead encourage them to 'lean more heavily on the Reserve Bank' for their financial requirements. Finally, the electricity industry was allowed a rate of return which was 2 per cent above the Bank rate, and keeping the latter at 3.5 per cent when the general pattern of lending rates and yields had

risen amounted to artificially depressing the rate of return allowed to firms in the industry.

Selective credit controls represented the second pillar of the Bank's policy in 1956–57. These controls expanded and intensified over the next few years. Besides, as these restraints were directed chiefly against foodgrains and other agricultural produce, their deployment threw up a conflict between the government's (and the Bank's) schemes to expand rural credit, and the shorter-term objective of price stability in a climate of inflationary expectations stimulated by high levels of public spending. That the government preferred, on the whole, to sacrifice rural credit to restricting inflation through more general methods reflected priorities which have been commented upon in other contexts as well. That the Bank, while cautioning the government about the inflationary effects of its deficits and about the problems associated with selective restraints, had eventually to take extensive recourse to them also reflects accurately its wider dilemmas in the context of India's development policies during these years.

#### SELECTIVE CREDIT CONTROLS

Although selective credit controls were introduced for the first time in May 1956, the Bank had been in the habit since World War II of advising or exhorting commercial banks to observe restraint in lending against shares and bullion, or against commodities like foodgrains. The Banking Companies (Control) Ordinance, 1948 gave the Bank power to regulate the direction of bank advances, but exhortations and advice remained the preferred methods. In the next few years the Bank began to develop a system to monitor and report on banks' advances against specific commodities. The latter included country piece-goods and yarn, cotton, kapas, jute and hessian, paddy and rice, gur and sugar, pulses, oilseeds, copra and gold. This system was backed up by occasional inspections so that by the middle of the fifties, a reasonably effective mechanism to monitor and enforce selective controls, if not always to accurately establish their necessity, was in place.

The immediate provocation for imposing selective controls in May 1956 was the doubling of banks' advances, as revealed by their monthly statements, against paddy and rice from Rs 11.6 crores at the end of March 1955 to Rs 24.6 crores at the end of March the following year. The increase in rice prices even in the midst of higher production also seemed to suggest the existence of some speculative fever in the market for the crop. Hence the Bank initiated consultations with the State Bank of India and the Central Bank, which between them accounted for the bulk of the advances against these commodities, and on 17 May 1956 issued its first selective credit control

directive under section 21(2) of the Banking Companies Act. This directive asked banks not to increase existing credit limits for advances against paddy and rice, not to sanction any fresh credit limits exceeding Rs 50,000 against these commodities to individuals, to raise existing margins in respect of loans against paddy and rice by not less than 10 per cent of their value, and to attempt to achieve a reduction in aggregate advances against them from current levels to 125 per cent or less of that in the corresponding period in the previous year. Broadly similar measures were promulgated in respect of 'wheat and other foodgrains' in September 1956.

Partly as a result of the directive but also under the influence of seasonal factors, advances against paddy and rice dropped from Rs 22.4 crores at the end of May 1956 to Rs 4.3 crores at the end of October. Following the decline in advances against rice and paddy during the 1956 slack season and in order to facilitate the transport and marketing of the new rice crop, the Bank withdrew its directive in November that year. Higher margin requirements on paddy and rice were reintroduced in February 1957, partly with an eye to the situation in Andhra Pradesh which accounted for a third of the total advances against the crop throughout India, and expanded to cover other foodgrains in June that year.

The Bank judged the 1956 selective credit control directive to have been 'reasonably successful' in its impact. But trade reactions to the policy were less positive. In a complaint to Finance Minister C.D. Deshmukh, some traders contended that there was little hoarding of paddy and rice and that banks' advances against the two commodities overwhelmingly financed legitimate trade in them. Besides they argued that the measure militated against trade in all primary commodities as banks might now hesitate to lend on their security. On a reference from the Finance Minister, the Bank stressed that trade fears of a fall in banks' credit against primary commodities were unfounded. Also, contrary to speculation, the May directive did not directly cause any capital loss to the banks but only affected those traders using bank funds to carry stocks in the hope of a rise in prices. Nor was the directive aimed at legitimate trading activity. It prohibited fresh advances and raising of credit limits but did not affect existing arrangements beyond prescribing an increase in the margin by 10 per cent. Finally, the Bank argued, the step was by no means permanent and would be eased or discontinued as conditions permitted.

From the latter half of 1957 the Indian economy showed signs of stagnation. The world economy too, was beginning to slow down following the onset of recessionary conditions in the United States. But inflationary pressures in the economy did not appear to be easing appreciably. A further constraining factor was foodgrains output which was over 10 per cent lower in 1957-58

than in the preceding year. The response of monetary policy to these events took the form of a progressive extension of selective credit controls. In June 1957 selective controls were applied to 'all foodgrains' and to sugar, and renewed, tightened, or modified regularly thereafter. Groundnuts were brought under selective controls in February 1959 and 'other oilseeds' in December the same year.

The proliferation of selective controls was largely, however, the result of the government's preferences rather than the Bank's. On the other hand while the Bank wanted the government to restrain public expenditure, it could not remain indifferent to the latter's concern about movements in the prices of key commodities like foodgrains and sugar, and of important agricultural raw materials or intermediate goods used by industry. The reintroduction of lending controls against sugar and foodgrains including paddy and rice in June 1957 was at the government's initiative, as were those on lending against sugar later the same month. In fact, governmental interest in selective controls extended to its highest levels, with Jawaharlal Nehru complaining to Iengar about banks allegedly flouting instructions to make large advances to millers and encouraging the hoarding of rice. The Prime Minister was also concerned that the Bank's lending to cooperative institutions contributed to rising food prices. As we discuss elsewhere in this volume, Nehru's misgivings perhaps related more to the Bank's approach to the overall organization of cooperative credit institutions than to the manner in which it administered its selective credit control policy. But the Finance Minister too favoured bringing cooperative credit institutions under the ambit of selective restrictions. Dissuading Krishnamachari from pressing his suggestion, Iengar pointed out that loans to cooperative societies against foodgrains were not very large and that their impact on grain availability and prices was mainly local in scope. Besides, the authorities were aware of the size of the stocks held by these agencies and would have little difficulty in requisitioning them should the need arise. Iengar also cautioned Krishnamachari against the dangers of reversing, at the first signs of difficulty, the government's strategy of increasing food output partly by financing farmers and their cooperative organizations to hold out for higher prices. While it was 'unfortunate' that this policy 'should have coincided with a period of rising food prices', the latter was not a 'sustainable argument' for changing it.

With the situation on the agricultural front threatening to cast a major shadow over the second plan, the air was thick during these months with suggestions to enforce State trading in foodgrains, if necessary on the basis of stocks procured compulsorily from farmers. These and similar ideas, which were sometimes aired at meetings of the National Development Council and

were believed even to have Nehru's backing, did not in the event translate into government policy. But it is worth pausing here to reflect on the irony of the Bank and the government debating, in the narrow, short-term, and somewhat unlikely context of monetary policy, some aspects of the role of the peasantry in the industrialization process, and of the Bank playing Nikolai Bukharin to the government's Preobrezhensky. With the second plan envisaging an accumulation process which the government had few levers of policy to effect, especially in agriculture, the impact of monetary policy instruments on the terms of trade between industry and agriculture acquired a salience few would normally attribute to them. Happily however, no lives were at stake in this re-enactment. Besides, Iengar not only kept his job, he also managed to bring Krishnamachari and the government round to the Bank's point of view on this subject.

In the early months of selective credit controls, the Bank had reasons to be worried about their enforceability. Inquiries revealed that commercial banks were not adhering faithfully to selective control instructions, while it transpired, in the course of the Governor's discussions with bankers, that the latter's head offices communicated Bank directives to the branches but thereafter did little to monitor their execution. The problem, according to Iengar, was the apathy, rather than defiance, of a 'mediocre crowd' of bankers who, while being 'pretty good at routine banking operations' were a 'poor lot' when it came to 'questions ... of general policy or ... new administrative techniques'. But the Bank's hand in dealing with the more recalcitrant banks was weakened because the State Bank of India happened to be one of the principal offenders. The former Imperial Bank which was taken into public ownership and rechristened in 1955 in order to serve as the government's instrument for expanding rural credit, had embarked on a programme of rapid expansion of its branch network. Many of these new branches were, as envisaged, in the rural areas, and advances against foodgrains represented the major part of their business and of their earning assets. Besides, as Iengar had correctly anticipated, it was not altogether easy for these branches to recall at short notice advances they had made to a large number of individual farmers. Finally, millers in the newly-created southern food zone had been forced by railway wagon shortages and newly imposed restrictions on food movement to build larger stocks than they wished to hold, and these could not be disposed of in a hurry except at a considerable loss. The State Bank therefore stressed the need for the Bank to coordinate its policy with the central and state governments, particularly in regard to zoning policy, food procurement, and the movement of foodgrains. In the event, regulation of credit against foodgrains became progressively wider and tighter during the remainder of



the year and the Bank also stepped up its monitoring of banks' implementation of these controls.

The Bank commissioned an internal study of the working of selective controls in July 1957. Although a number of officials at the Bank, including the Governor, were not happy with many aspects of the instrument, the study was provoked chiefly by the insistence of D.R. Gadgil, a member of the Bank's Central Board, that these controls were neither 'effective nor sound'. Iengar was also impressed by Australian studies which revealed that qualitative controls were not a happy experience for any of those involved in or affected by them. After surveying the working of qualitative controls in a few countries, the Bank's study came to the rather obvious conclusion that their effectiveness turned on a number of factors including the objective in pursuit of which they were deployed, the general financial and economic climate, notably the presence of inflation or inflationary expectations, and the institutional framework. Besides, it noted, qualitative controls could not substitute for quantitative instruments, and in fact the former depended on the latter for their efficacy, particularly where inflationary pressures were pronounced.

The study's findings about the Indian experience with selective controls were more interesting. Few major foodgrain traders, according to the study, possessed alternative assets such as government securities or shares. Therefore, restricting credit against foodgrains would directly affect their inventory behaviour. Although the volume of clean advances had gone up since selective controls were imposed and this merited investigation, foodgrain traders were unlikely to have been significant beneficiaries. The study also found that bank credit played an important part in financing trade in cotton textiles and sugar. The market for paddy and rice was, however, more differentiated in its dependence upon bank credit. Small traders specializing mainly in local and intra-state trade did not usually finance their stocks by borrowing from banks. On the other hand, though only a small proportion of the marketed surplus in rice found its way to markets outside the state producing it, bank credit financed an important share of this trade. This tendency was particularly pronounced in the major rice-surplus states of Andhra Pradesh, Madhya Pradesh, and Orissa, so that controls on lending against the grain could play a 'strategic role' in these three states. Interestingly, the measure did not really cause much hardship to genuine traders because they tended progressively to reduce their commitments in the slack season. Besides, trade being now psychologically more alert than earlier, the uncertainty of bank credit might dissuade operators from overextending their commitments. Selective controls had done little to move credit away from trade and towards industry; but while operating negatively, there was no evidence that banks' funds rendered

surplus by the measure were being diverted into other undesirable—but unregulated—uses.

The study also found that Bank directives to commercial banks to raise margins by a specified percentage affected different borrowers differently, since the initial condition, i.e. the margins originally charged by the banks on the same securities, varied. This problem could be avoided if the Bank imposed minimum rather than incremental or additional margin requirements. Finally, it stressed the importance of the Bank developing more knowledge about the functioning of markets, patterns of financing commodities and of arrivals and despatches, and estimates of stocks with trade, in order to better assess the reasonable requirements of trade for credit and intervene to curb speculation in a more timely fashion. But this was easier said than done. Besides, with selective credit controls often becoming a substitute for action along a wider front, the Bank came to feel that they always tended to ‘come late’ and were ‘largely circumvented’. It was therefore necessary, the Bank believed, to ‘act in advance and ... as much as possible through restriction of credit generally, than through a maze of separate, specific directives, which are got around’.

#### VARIABLE RESERVE RATIOS

Despite all the reservations, monetary policy during the next two years mainly revolved around selective credit controls. In addition, the Bank initiated closer consultations with bankers over credit policy, routinely exhorting them to follow the guidelines it issued at the beginning of each season. During the 1959–60 busy season, however, the price situation became a source of heightened concern, with Iengar urging the Finance Minister in January 1960 that it ‘must be tackled energetically if we are not to find ourselves in deeper waters’. Besides, it emerged that after two years of relative moderation, the growth of bank credit to the private sector had begun once again to acquire sizeable dimensions. Although the upswing in industrial activity continued, industry was clearly yielding to trade in the allocation of bank credit. Clean advances were also ‘showing an unusual rise’. The Bank attributed the higher trade demand for credit to ‘large inventory profits in one line [sugar and cloth]’ feeding ‘hoarding propensity in other lines’, and creating an ‘artificial glow of prosperity’. The Bank was also nervous that credit-aided speculation might push up the raw material costs of industry. The bourse, assisted to some extent by a sharp increase in banks’ advances against shares and direct financing of *badla* (or carry forward) transactions, came under the grip of boom conditions and the Bank interpreted the rising index of variable dividend industrial securities as a further sign of the ‘abundance of money and liquidity in the economy’.

Alongside booming credit, bank deposits too increased rapidly. Thanks to rising deficit-financed public expenditures, bank deposits increased some 17 per cent in 1959 on top of a similar rate of increase in 1958 and 23 per cent growth in 1957. The substantial part of this increase was in the form of demand deposits. Besides, it was believed that the term structure of deposit rates which came to prevail in October 1958 as a result of an inter-bank agreement (on which more below) had led to the bulk of the expansion in time deposits taking place in the shorter categories. Another notable trend in recent years had been the rise in the velocity of bank money from 45.7 in 1956 to 48.6 in 1957 and 55.5 in 1958. The Bank expected this velocity to show a further rise when figures for 1959 were assembled. These trends indicated, in the Bank's opinion which was recorded in a detailed note sent to the Finance Minister in February 1960,

some decisive action ... to curb the creeping ascent of prices, to promote saving and to divert investment from avenues that seek quick riches and facile gains to channels that lead to sustained growth of the economy.

Although production was still 'well sustained', there was also the danger that the 'inflationary atmosphere' might distort the pattern of incentives against 'higher production, greater efficiency, and increased savings'.

In such a situation, action to restrict credit in respect of individual commodities, e.g. cotton textiles or sugar or jute, will not be adequate, for excessive liquidity ... has a way of breaking through any complicated network of selective controls .... The action required, therefore, is some measure of general restraint of monetary expansion, lest the objective of growth with stability should be jeopardized and, in the process, growth itself be retarded.

The Bank's recommendation evoked little immediate response from the government. The decision to tighten monetary policy was finally taken a month later in March 1960, but the new policy was different in its emphasis from what the Bank had envisaged in February. In keeping with the trend of the past two years selective controls were extended further, now to cover ordinary shares and clean advances. There was in addition a substantive policy change—a new *general* instrument—in the form of higher marginal reserve requirements.

The decision to impose higher marginal reserve requirements came into effect on 11 March. Scheduled banks were henceforth to maintain with the Reserve Bank additional reserves equivalent to 25 per cent of the increase in

their deposit liabilities from that date. In order to compensate for the interest cost banks bore on these additional reserves, they were allowed interest on the latter at the average rate they paid on deposits during the corresponding quarter, with the Bank rate as the ceiling. Before long this rate was felt to act as a disincentive for deposit mobilization, and in June the Bank raised the interest rate on additional reserves to half a percentage point above the average deposit rate during the half-year, subject to a ceiling of 4.5 per cent, or half a per cent above the Bank rate.

The March measures were not entirely without effect. The increased margin on shares and the ban on *badla* financing by banks and clean lending helped give teeth to the existing regime of selective controls. Taken towards the end of the busy season, the enhanced reserve requirements were probably designed more to ensure slack season reduction in credit than to check the expansion of busy season advances. Nevertheless, the immediate impact of the measure on bank credit was not negligible. Busy season advances between the beginning of November 1959 and 18 March 1960 stood at Rs 173 crores, as against about Rs 158 crores for the same part of the preceding peak season. But during the remainder of the busy season, when the increased reserve requirement began to affect banks' resources and up to the end of April 1960, bank advances were lower at Rs 16 crores as against about Rs 23 crores for the corresponding period of the preceding year. As a result, although peak season advances during 1959-60 exceeded the preceding year's record figure of Rs 182 crores, the increase over the previous year was held down to about Rs eight crores.

However, after declining from 119.4 on 27 February to 118.6 on 26 March, wholesale prices rose to 121.7 by 23 April. By the end of April the index of variable dividend securities too, recovered from a brief fall to breach the pre-March 11 level. Besides, the pace of credit contraction was too slow for the Bank's liking. These factors persuaded the Bank to increase the marginal reserve ratio once again, and on 6 May 1960 banks were directed to maintain additional reserves equivalent to 50 per cent of the increase in their deposit liabilities from that date. Immediately thereafter, Iengar wrote to scheduled banks urging them to contract bank credit during the slack season by Rs 110 crores, particularly against seasonal commodities, while major banks were individually advised of the order of contraction they should effect.

#### REGULATING ACCESS TO THE RESERVE BANK

The two-step increase in reserve requirements did help squeeze the liquidity of the banks. Excluding the State Bank of India, whose deposits declined under the impact of the new arrangements instituted for P.L.480 funds, free

reserves of banks (defined as cash *plus* excess reserves) declined from Rs 64 crores on 18 March to Rs 39.5 crores on 16 September 1960, the ratio of these to their deposit liabilities falling from 4.9 per cent to 2.9 per cent. But on balance, higher reserve requirements failed to achieve their intended purpose of moderating the expansion of bank credit and bringing about its effective contraction in the slack season. Rather, with demand for credit against non-seasonal commodities remaining high, bank credit confounded expectation and the seasonal pattern, to *expand* by Rs 4.6 crores during the 1960 slack season.

There are, even from the perspective of the Bank's own history, some unexplained aspects to its recourse to marginal reserve ratios in March 1960. Apart from the Bank note which made the case for a tighter monetary policy in February 1960 placing its emphasis somewhat differently from the policy which was subsequently adopted, it is useful to recall that so recently as 1958–59 the Bank had tended to play down the role of variable reserves in its 'comprehensive armoury of weapons of credit control'. According to the Bank's replies to the questionnaire circulated by the Radcliffe Committee, varying reserves was unlikely to have the 'same efficacy' in India as in other countries where there was

scope for large scale multiple expansion of credit. The calling of fresh reserves would certainly help to curtail credit ... but in the Indian banking context it would need a much greater variation in the level of reserves to induce the same effect on bank credit than would be necessary in countries with a fractional reserve system.

One explanation for the mystery behind the deployment of this instrument in March 1960 may lie in the fact that the government was perhaps not as keen as the Bank to see a rise in the Bank rate at the time and that variable reserves may have been seen as a promising compromise between the two positions. In the untested weapon's favour was the expectation, as the Bank told visiting IMF officials in December 1961, that 'it could take effect very quickly'. The Governor, on the other hand, appears to have considered raising the Bank rate, if not in March, certainly in April and May 1960 and again in June. On the last occasion he sought expert opinion on the likely impact of a higher Bank rate on the gilt-edged market and received in return a note which suggested that it would be quite significant. Recounting the year's credit policy developments in December 1960, a memorandum by the Executive Director, B.K. Madan, informed the Bank's Central Board that a higher Bank rate was not resorted to in March because the level of borrowing from the central bank was not 'unusually large'; so that for it to be effective, the Bank

rate hike would have had to be 'rather sharp' and this would have 'caused disturbance to the government securities market with the borrowing season ahead'. There is some evidence that the Bank and the government did not see eye to eye on the merits of a generalized 'dear money' policy later in the year when a new accommodation regime (discussed below) was decided upon by the Bank. Again in December 1960, there was widespread speculation in the press and elsewhere that the central government stood in the way of the Reserve Bank raising its rate. One may read this difference back to the beginning of the year, citing in support for so doing, simmering Bank-government differences over monetary policy since virtually the beginning of the second plan. But the most that can be said at this stage with any degree of confidence is that for so major a step, the decision to vary marginal reserve ratios appears to have been taken rather suddenly, almost peremptorily, with the Bank's confidential agenda-setting monetary policy note sent to the Finance Minister a month or so earlier making no mention of it. All else must remain conjecture in the present state of our knowledge.

Variable reserves failed for a number of reasons, but largely because of conditions prevailing in the credit market. Faced with a high and rising demand for credit and a rather unexpected fall in deposit resources after three years of rapid growth, banks found a number of quite legitimate ways to offset their impounded reserves. Apart from reducing their cash in hand and excess balances with the Reserve Bank—which together increased by Rs 1.4 crores in the 1959 slack season but fell by nearly Rs 25 crores through the 1960 slack season—banks also sold government securities to augment their resources. Banks' holdings of these securities tended usually to fall in the peak season and rise in the slack. During the 1958-59 peak season for example, banks reduced their holdings of government securities by Rs 3 crores and in the following slack season invested Rs 52.2 crores in them. In 1959-60 however, banks' peak season disinvestment amounted to Rs 53 crores. They followed this up in the ensuing slack season with further sales of government paper to the tune of Rs 4.7 crores, the latter figure almost exactly equalling the contra-seasonal increase in bank credit during these months. As a result, the aggregate ratio of investments to deposits of banks dropped from 32.3 to 27.8 per cent during the year ending September 1960. The third course banks adopted to augment their resources exposed a major chink in the Bank's credit policy armoury. This was to maintain large outstandings on the accommodation they drew from the Reserve Bank. Being another—relatively cheap—source of banks' funds, such borrowing too usually increased during the busy season, but shrank as demand for credit eased in the summer. During the 1960 slack season however, despite accommodation under the bill market scheme being

made more stringent, scheduled banks effected a smaller reduction than in the past of their debit balances with the Reserve Bank which totalled Rs 33 crores at the end of the slack season in September 1960, as against a mere Rs 3 crores a year earlier. This increase was reflected in the aggregate ratio of unencumbered securities to deposits of banks, which fell sharply from over 31 per cent in September 1959, to 23 per cent a year later. The fall in these proportions, particularly those for free reserves and investments, was more pronounced for banks other than the State Bank of India.

Clearly therefore, the unrestricted accommodation it offered banks and the latter's freedom to liquidate government paper undid whatever the Bank hoped to achieve through higher marginal reserve requirements. The banks' response could have been foreseen, and indeed was in 1956 when power was acquired to vary scheduled banks' reserve ratios. The Bank was already alive to the declining trend in the level of banks' slack season excess balances. But decisions on the level of excess reserves or cash balances to be carried were entirely for the banks to take, the central bank having no role to play so long as the legal requirements under the Reserve Bank of India Act and the Banking Companies Act were satisfied. In 1955, officials also contemplated the possibility of banks selling government securities to side-step the impact of higher reserve requirements. But opinion at that time was formed by the expectation that the latter would be imposed in a climate of rapidly rising deposits, and secondly that the demand for credit would not be inordinately high. In these circumstances, there was no particular reason to expect (a) that banks would experience a *fall* in their level of free reserves, and (b) that they would attempt to restore it by liquidating investments rather than reducing advances. But in 1960, both situations materialized.

The third possibility, of banks increasing their recourse to the Reserve Bank for accommodation, was not considered seriously by the Bank's Department of Research and Statistics in 1955. Simha's note, to which attention was drawn in the previous chapter, took cognizance of this possibility only to the extent it highlighted the tight reserve position banks were likely to face. The latter, in turn, was seen to be propitious for the success of variable reserves in India. Madan's note on variable reserve requirements too, completely ignored the possibility of banks taking recourse to loans from the Reserve Bank to circumvent higher marginal reserve requirements. On the other hand the Department of Banking Operations' office note opposing the proposed amendment had argued that commercial banks in India, unlike those elsewhere, did not 'disfavour borrowings from the Reserve Bank even during the slack season' because they had a high advances-to-deposits ratio by international standards and little excess liquidity. So that while higher

reserves were not indicated in these conditions, their imposition could be defeated by banks increasing their borrowing from the central bank. An implication of this argument was that restricting Bank lending to commercial banks would be more effective in checking their ability to expand credit than impounding additional reserves.

In the event, experience taught the Bank the same lesson within months of its decision to impose higher reserve requirements in March 1960. The ease with which banks decided to shed their investments in government securities came as something of a revelation, and the Bank was soon to initiate steps to limit their freedom in that respect. But the more immediate impact of recent developments upon the Bank's thinking was reflected in its resolution, reached by September 1960, that it had become necessary to 'curtail the present unlimited access of banks to the Reserve Bank and to prevent the monetization of Government debt'. The Bank also thought it 'inadvisable' to lend large amounts to the banks when the government was adopting inflationary methods of financing its investment projects. More widely, after the bill market scheme was instituted, banks had grown used to

dependence on borrowing from the Reserve Bank, so that their cash ratio [has] become progressively smaller. Such a situation was far from healthy. Besides, recourse to the central bank should normally be ... temporary ... [and confined to] financing the heavy busy season demand. For the rest, the banks should rely on the growth of their own resources to meet the expanding demands of trade and industry.

One of the reasons for the high level of banks' borrowing from the Reserve Bank was the low rate of interest of 4 per cent the Bank charged on its loans. Besides, the effective cost to the banks of their borrowing from the Reserve Bank of India to offset the impounded reserves was the difference between the Bank rate and the rate which the Bank paid on the additional reserves. By September 1960, arguments for a general policy of credit restraint had been strengthened by external developments, notably the continued loss of reserves despite tighter import controls. 'To a not insignificant extent,' therefore, in the Bank's opinion, 'external stability and internal stability [were] interlinked'. An increase in the Bank rate from the prevailing 4 per cent might restrain demand for credit as well as that for Bank accommodation. But the problems which the free use of this instrument posed for the government loan market could not be ignored any more in the autumn than it could be in the spring. On the other hand, physical credit rationing through a system of quotas for individual banks in the system was too inflexible a method to be of much real



value. Hence, the Bank decided to attempt rationing its credit to the banks through a price instrument which would at the same time not directly increase the cost of government borrowing or affect the gilt-edged market.

Thus was born the 'quota-slab' system instituted from 1 October 1960. Adapted from the contemporary French system of *enfer* and *super-enfer* and a similar Japanese practice, the proposed system of 'graded lending rates' or 'penal rates' originally assigned to each scheduled bank a quarterly quota equal to half the average volume of reserves required to be maintained by it under section 42(1) of the Reserve Bank of India Act during each week of the preceding quarter. Loans from the Bank within the quota were charged interest at the Bank rate. Borrowings above this limit and up to 200 per cent of the quota attracted a penal rate of one per cent above the Bank rate, while loans in excess of even this quota were granted only at the Bank's discretion in the form of 'special accommodation' which attracted a penal rate of 2 per cent above the Bank rate. These rates also now applied to advances under subsections 4(a) and 4(c) of section 17 of the Bank Act, so that it thereafter became unnecessary to fix separate ceilings for individual banks for borrowing under the bill market scheme. As penal rates helped restrain their borrowing from the central bank, banks' aggregate lending could also be expected to fall. But since the direct impact of the new measure was expected to vary with the extent of a commercial bank's reliance on the central bank for accommodation, the Bank sought to reinforce its restrictive impact by instructing commercial banks to adhere to a minimum lending rate of 5 per cent and to raise their average lending rates by at least half a per cent over the rate prevailing on 30 June 1960. The latter initiative, incidentally, marked the Bank's first entry into the area of lending rate regulation. To plug another possible loophole, some restriction was also introduced on the scope of the Bank's open-market operations, outright purchases now being confined to loans maturing in 1961.

Although the new accommodation regime made them superfluous, additional reserve requirements were persisted with in the existing form for some more weeks despite growing pressure from business, and to some extent from the government, to relax them. Finally on 11 November 1960, eight months after they were first introduced, the Bank began scaling down these requirements partly to guard against any undue stringency in the credit market during the peak season then getting under way. In the first instance the Bank waived the marginal reserve requirement on future additions to banks' deposits. In addition, the higher reserve requirement placed on deposits made between 11 March and 11 November was reduced to 25 per cent, thereby enabling the Bank to release Rs 14 crores, or about half the reserves impounded until then. Additional reserve requirements were finally revoked in their entirety on 13 January

1961 and an amount of Rs 13 crores released to the banks in consequence. In the Bank's evaluation, its experience with the instrument was not 'satisfactory', and officials of the Bank confessed to IMF officials their doubts that 'they would resort again to incremental requirements in the near future'. The use of the instrument, which was now potentially more effective following changes made meanwhile to the accommodation regime and to cash and statutory liquidity requirements, was considered briefly in 1965 and again in 1966, but it was not redeployed again during the years covered by this volume.

The new quota-slab system and the Bank's directive on lending rates led to a down the line increase in lending rates. The State Bank too, took steps to reduce its accessibility for other banks by raising its lending rates to 6 per cent from 4.25 per cent at places where the Reserve Bank had offices. At other places it charged 5 per cent but imposed some restrictions on the amount of lending it undertook. The State Bank's rate on loans to cooperative banks was also raised to 4.5 per cent from the earlier 4 per cent. In the wake of these measures, scheduled bank credit declined by Rs 29 crores between 30 September and 25 November 1960 against a rise of Rs 3 crores during the same period in 1959. Money rates also firmed up, the inter-bank call money market rate rising to over 4.6 per cent by the end of the year and to 5.25 per cent in January 1961. Unavoidably, rising interest rates elsewhere in the system could not but affect the market for government securities. Although the immediate effect on central government loans was small, loans of state governments came under greater pressure. The impact of the new regime was also felt in the unorganized sector. In Bombay, Multani *shroffs* raised their lending rates from the 9-11.25 per cent which prevailed on 7 October 1960, to 12 per cent a week later. In upcountry centres too, stated rates were reported to have touched the legal maximum of 12 per cent.

The system of graded lending rates which lasted for four years till September 1964 had some undoubted advantages, combining as it did elements of quantity and price rationing. It did not directly affect the yield on long-term securities and sought to achieve credit restraint with a gradual adjustment of the prices of government securities. Besides, under this system, the marginal lending rate could be raised to much higher levels than would be possible if action were contemplated directly on the Bank rate. The system was also not inflexible, in that both penal rates and quotas could be varied as circumstances dictated. In contrast, Bank rate decisions would be attended by too many considerations for quick or frequent changes to be possible, or even desirable.

However, this method could never produce on the market quite the same psychological impact as a rise in the Bank rate. The rise in lending rates

which followed the introduction of the quota-slab system was neither uniform nor orderly. Some lending rates, for example, were linked to the Bank rate and could not be increased without raising the latter. An effective interest cost higher than the Bank rate also created difficulties for electricity undertakings and others whose returns were linked to the latter.

In practice too, the quota-slab system was not as effective a quantitative check as hoped. Firstly, the quotas were fixed on a uniform basis so that both banks with high credit ratios and those with low credit ratios were treated on the same basis. This arrangement also encouraged banks with high liquidity ratios to increase their holdings of treasury bills rather than invest in dated securities. By allowing the former to run off during the busy season, such banks were able to obtain funds outside quota arrangements. Further, the freedom commercial banks had to pass on (or not pass on) the higher cost of borrowing from the Bank to their customers also mitigated the restrictive impact of penal interest rates.

Despite these problems, the quota-slab system remained in place as an important component of the Bank's credit policy apparatus during the next four years. The regime was further tightened in July 1962 preparatory to approaching the IMF for a standby arrangement, by reducing the basic quota and adjusting the Bank's lending rates on the other slabs. The latter were now four in number, and the interest rate on the highest slab was fixed at 2.5 per cent above the Bank rate. The net effect of this tightening was to raise the Bank's average effective lending rate by half a per cent or more. This increase was also reflected in the higher yields offered by the central government on the loans it issued later the same month. Thereafter the quota-slab system was liberalized or tightened as necessary on a few occasions before being replaced on the eve of the 1964–65 busy season by a scheme of accommodation based on banks' net liquidity ratios (or NLRs).

#### COMMERCIAL BANKS AND CREDIT POLICY

The reliance placed upon selective credit control instruments and the nature of the general control instruments it deployed obliged the Bank to develop close contact with commercial banks. Against this background, the bank used 'moral suasion' both to alert bankers to emerging trends which if not checked in time would invite Bank intervention, and to buttress its monetary and credit policy measures. The Bank sometimes chose to signal its approach to issues concerning monetary policy and the banking system through the speeches the Governor and his deputies made to important bodies such as the Indian Institute of Bankers. There were, besides, two channels of moral suasion which the Bank adopted on a more routine basis. Regular meetings between

the Governor and bankers were one. Apart from giving bankers an opportunity to ventilate their problems, the Governor used these meetings to elucidate the Bank's thinking on monetary policy and other issues and to exhort bankers to more closely observe the Bank's credit policy advice and directives. Meetings of this nature proved particularly useful in assessing the pulse of the market for credit, in removing (or reinforcing) bankers' misgivings about the extent to which they could rely on the Bank for accommodation, especially under the bill market scheme, and for understanding the difficulties banks faced in giving effect to policies of the Bank such as those on selective credit control. As these meetings became more frequent bankers also ceased presenting a monolithic front to the Bank, and although not all bankers were equally forthcoming, some issues were discussed on their merits rather than in a partisan spirit. The seeds of the Bank's policy to regulate its accommodation to commercial banks, for example, may well have been sown at one such meeting.

Regular letters from the Governor to heads of scheduled banks formed the other major channel of direct communication between the Reserve Bank and the commercial banking system. Both channels were used, particularly starting from the 1956-57 busy season. To some extent the general credit policy during that season bore the impress of the many meetings the Finance Minister and the Governor held with bankers. But despite these efforts and the restraining impact of the monetary policy measures of May 1957, credit continued to expand, the level of outstanding credit touching Rs 938 crores on 7 June 1957. Viewed in the light of rising prices and the volume of deficit financing projected for 1957-58, this was a worrying trend for the Bank. Therefore Iengar wrote to the banks towards the end of June 1957 exhorting them to reduce outstanding bank credit during the slack season and to bring down the credit-deposit ratio without reducing assistance to essential sectors, particularly industry. The Governor urged the banks also to reduce advances against agricultural commodities in short supply, and to reduce their recourse to Bank accommodation. This letter was partly an attempt to translate systemic objectives and targets to the level of individual banks within it. It was followed up by a wider appeal to bankers, whom Iengar addressed in Bombay and Calcutta in July and August 1957 respectively, to bring down the level of advances to about Rs 800 crores by the middle of October, since this represented in the Bank's judgement, a manageable base for credit expansion during the next busy season. This counsel was not entirely lost on the bankers. Aggregate credit declined from its June peak to Rs 847 crores by the end of September. But for certain fortuitous events the fall might have been even larger.

In the months which followed, the Governor continued to exhort bankers to refrain from making advances for speculative purposes, to closely scrutinize clean advances and discourage the practice of rediscounting clean *hundis*, and to reduce recourse to the Bank for accommodation. In the communications he issued at the beginning of the slack season, the Governor was also inclined to lay down suggestive figures for the extent of the off-season contraction of credit to be effected by the banks, Rs 100 crores in 1959 and Rs 110 crores in 1960. The latter suggestion, which in the event was not heeded, followed close on the heels of the increase in variable reserve requirements to 50 per cent in May 1960, while the original decision to impose additional reserve requirements in March 1960 had been preceded by more than one appeal from the Governor to bankers to restrain credit expansion during the 1959–60 peak season.