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The Difficult Years, 1961–67

With two wars, a series of poor harvests including two droughts, and an unstable external environment, the 1960s were years of severe strain for the Indian economy. The demands on the exchequer rose as the needs of defence had to be met alongside those of development and the increased public expenditure financed against a background of stagnating agricultural production, unimpressive industrial growth, and a largely stagnant savings rate. Agricultural production barely rose above the 1960–61 level until 1964–65, dropping nearly 10 per cent in 1965–66, which was the first of two successive drought years. Food production too followed the same trend, stagnating until 1964–65 around or below the 72 million tonnes per year mark reached in 1960–61. Output rose to 78 million tonnes in 1964–65, but dropped nearly a fifth to a mere 63 million tonnes in 1965–66. It rose slightly to 65 million tonnes the following year before recovering to 80 million tonnes in 1967–68.

Consequently, these were also years of considerable price instability, the rate of inflation rising sharply from an underlying rate of below 3 per cent per annum during the first three years of the third plan to about 13 per cent in 1964–65, 8 per cent in 1965–66, and to a postwar high of nearly 16 per cent in 1966–67. The effect of price instability on the country's food economy was particularly pronounced, the wholesale index of foodgrain prices rising by over 26 per cent in 1964–65, 6 per cent in 1965–66, about 18 per cent in 1966–67, and again by a quarter the following year. For the years 1961–69 as a whole, the annual average increase in wholesale foodgrain prices was of the order of about 10 per cent.

The balance of payments remained under considerable pressure during the third plan. But assisted partly by import compression, the current account deficit fell steadily in absolute terms and as a percentage both of exports and of the national income during the first three years of the plan. Although the deficit rose sharply in 1964–65, it was still only about 1.7 per cent of the

gross domestic product. But from about $0.9 billion in 1964–65, the current account deficit ballooned to about $1.2 billion and $1.57 billion in the next two drought-affected years, or to 2.2 per cent and 3.7 per cent respectively of the gross domestic product. This coincided with a worsening of the external aid environment, particularly in relation to the United States. Following the rupee's devaluation in June 1966 and sustained efforts at fiscal and monetary stabilization the current account deficit dropped steadily in the next three years, bottoming out at $0.43 billion in 1969–70 when it represented under one per cent of the gross domestic product.

Despite a stagnant agriculture, the manufacturing sector witnessed impressive rates of growth in all but the concluding year of the third plan. Thereafter, however, the declining availability of food and agricultural raw materials and stringent import controls, which affected supplies of intermediate goods, triggered an industrial recession. This was reinforced on the demand side by the decline, both in real terms and as a share of national income, of gross fixed capital formation in the public sector which followed the end of the third plan. The prolonged period of stagnation in Indian industry since the mid-1960s has been the subject of wide comment. It is sufficient to note for our purposes, however, that real manufacturing GDP grew by less than one per cent per annum in the three years starting 1965–66; and although manufacturing growth was a more respectable 5.5 per cent in 1968–69, this was considerably below the rates witnessed since the mid-1950s.

Not surprisingly, the overall growth performance of the economy was lacklustre during the third plan period. Poor growth rates in the first two years of the plan and a negative growth rate in the drought-affected terminal year meant that real national income grew by less than 14 per cent during these five years, as against nearly 22 per cent during the preceding plan period, and the plan target of 30 per cent. This represented, in annual terms, a growth rate of incomes which barely outpaced the rate of population growth. Although the economy grew at over 8 per cent during 1967–68, growth remained poor (one per cent and 2.6 per cent respectively) during the other two annual plan years.

At one level, the task facing the monetary policy authorities during the 1960s was little different from that in the preceding years: the Bank had once more to ensure that the resources of the banking system did not go into speculative or socially unproductive channels, and that the legitimate needs of industry and trade (including during much of this period the needs of those sections of it geared towards meeting the needs of the country's defence) were met as far as possible. In practice, however, higher rates of inflation and the build up of inflationary expectations in a climate of severe shortfalls in the availability of food and other agricultural products and imported

intermediate goods rendered this task more difficult than before. Neither could the Bank adopt a rigid attitude towards the growth in public expenditure. Although the finances of the state governments deteriorated faster than those of the central government in the mid-sixties, the Bank could hardly afford to ignore the need for additional public spending in the wake of threats to the country's security and the drought situation. Finally, by the middle of the decade, the balance of payments position took a turn for the worse and the Bank had to contend not only with the need to stabilize the external sector but also to minimize the domestic inflationary fallout of the rupee's devaluation in June 1966; and for much of the closing years of the 1960s, monetary policy, while keeping inflation at bay, had also to attempt to mitigate the impact of the severe industrial recession brought on by import compression, the decline in public investment since 1965–66, and the foodgrains bottleneck.

The first half of the sixties were fairly active years from the point of view of the Bank's monetary policy. Unlike during the second plan, the easy option of putting off interest rate changes to protect the government's borrowing programme was no longer available. The Bank rate was put up thrice during the third plan, on the last occasion by a full percentage point to 6 per cent. This greater freedom of interest rate policy was partly secured by modifying banks' liquidity requirements and the Bank's accommodation regime to promote the market for government securities. Arguably therefore, rather than squeezing government spending, monetary policy was forced during these years to accommodate it. The longer-term effects of this measure on the allocation of credit between the government and the private sectors fall beyond the scope of this volume. It can however safely be said that these effects were not immediately apparent since stabilization became the dominant objective of the fiscal regime within months of the rupee's devaluation in June 1966. Selective credit controls were also in full play during these years but the Bank attempted to use them also as a positive instrument to encourage credit to flow into critical export and defence-related sectors. This the Bank was able to do because regulating commercial banks' access to central bank credit, first attempted towards the end of the second plan, became by far the most important weapon of monetary policy during the third. Mainly a general weapon of control, the Bank selectively relaxed it to refinance bank lending to certain preferred sectors.

CREDIT POLICY, 1961–64

The quota-slab system instituted in October 1960 remained the dominant feature of the accommodation regime for the greater part of the third plan

period. Rapid deposit growth, poor slack season contraction, and concern over rising prices forced a further tightening of access to Bank accommodation and, as pointed out in chapter 3, a four-tier system of lending rates was introduced in July 1962 which raised the Bank's average lending rate by half a per cent or more. The basic quota, which could be replenished at the Bank rate, was lowered to 25 per cent of the average statutory reserves of the bank for the preceding quarter. Borrowings in excess of this quota were charged at rising rates of one, 2, and 2.5 per cent above the Bank rate. The yields of the new central government loans announced at the same time were also fixed above those prevailing on securities of comparable maturity, the Bank viewing these measures as being necessary to adjust the pattern of rates in the money and capital markets to reflect the savings–investment gap in the economy. These adjustments also helped ease the disquiet at the International Monetary Fund and elsewhere, especially in the run up to discussions about the July 1962 standby arrangement, over the rigidity of India's interest rate policies.

The 1962–63 busy season was overshadowed by the border conflict with China. There were other complications as well. The expected seasonal fall in prices did not materialize, while industrial growth remained sluggish and foreign exchange reserves declined rapidly. Credit contraction had remained tardy during the preceding slack season despite the revised accommodation formula. During the last peak season scheduled bank credit of Rs 200 crores had been financed to the extent of nearly two-thirds from banks' own resources and the Reserve Bank expected this to be repeated, especially as the rise in defence expenditure could be expected to lead to a rise in banks' deposits. Hence the Bank felt justified in further tightening the accommodation regime, and from the end of October 1962 it introduced a three-tier system with the peak rate of 2.5 per cent above the Bank rate coming into operation for accommodation in excess of the level of a bank's statutory reserves. Such accommodation was moreover expected to be temporary, lasting no more than a week or so, with the Bank resolving to charge 'really penal rates' should it appear to be becoming a permanent feature. Borrowings between a quarter and a half of the statutory reserves were to be charged at one per cent, and those between 50 per cent and 100 per cent at 2 per cent above the Bank rate.

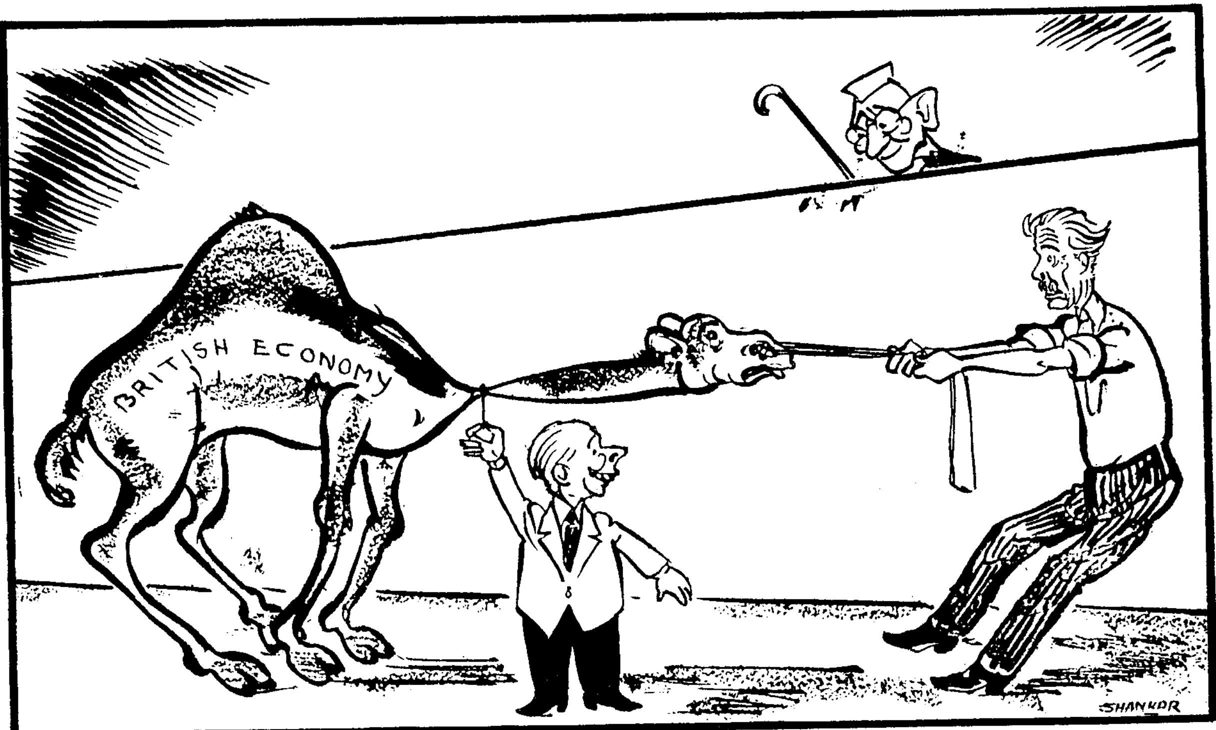
The new accommodation regime, as mentioned earlier, led to the firming up of lending rates in the market. Although the Bank rate remained formally at 4 per cent until January 1963, the average cost of borrowings from the Bank worked out to 5.46 per cent at the end of March 1961. The tightening of the terms of access to Bank credit in July 1962 added another half a percentage point to the Bank's average lending rate. Rates on the government's market

loans and on small savings also went up by half to one per cent, the lending rates of the banks moved up by half to two percentage points, and those of term-lending institutions, such as the Industrial Finance Corporation, state financial corporations, and the Industrial Credit and Investment Corporation, by half a per cent. The anachronism of a 4 per cent Bank rate which was out of line with market rates figured prominently during Art. XIV discussions with the Fund at the end of December 1962. The Bank itself was inclined to formalize the rate changes it had inaugurated several months previously, and decided on 2 January 1963 to raise the Bank rate by half a per cent to 4.5 per cent.

The Bank rate increase of January 1963 brought the curtain down on nearly three years of disagreement on this measure between the Reserve Bank and the Government of India. In the meantime, however, the Bank had raised its effective lending rates through the quota-slab system, and the new measure was intended mainly to bring the Bank rate once again in alignment with other interest rates in the market. Mint Road did not wish the hike to be read as a signal for dearer money, and the Governor advised commercial banks against passing the increase on to their borrowers since the average rate at which they borrowed from the Reserve Bank during the second half of 1962 was considerably higher than even the new Bank rate. Also in the Bank's view, it was important to avoid the 'impression among the borrowing public that the banks were forcing ... higher rates by ... entering into a sort of "cartel agreement" ' amongst themselves. Nor could they afford to ignore the effect of higher lending rates on the government's borrowing operations. The Bank however failed to have its way, as the banks insisted that although very little lending took place at 6 per cent, a 2 per cent margin over the Bank rate was the minimum required to maintain their earnings. The minimum lending rate was consequently raised to 6.5 per cent and before long, the State Bank of India and the term-lending agencies too raised their rate on loans by half a per cent.

Alongside the increase in the Bank rate, the quota-slab system was simplified, borrowings up to 50 per cent of the statutory reserves being permitted at the Bank rate, and the balance at 6 per cent. Borrowings in excess of the statutory reserves were permitted at 6.5 per cent. Since October 1962 the quota-slab scheme was operated more flexibly to take into account the needs of defence production, essential industries, and the export sector. Banks were also asked to reassess their advances portfolio, refuse advances where there was reason to suspect that they might be used for hoarding or speculation, and to consider recalling unsecured advances and those secured by gold and shares. The policy of granting preferential treatment to special

The Needle's Eye



By raising the bank rate, Britain hopes to ensure consumer austerity and step up exports.

– *Shankar's Weekly*, 30 July 1961

sectors (such as small-scale industries and cooperatives) was also extended; and in March 1963 an Export Bills Credit Scheme was instituted for making advances at a slightly lower cost, the stamp duty being exempted, against demand promissory notes backed by a declaration by the borrowing bank that it held eligible export usance bills in its custody.

Credit contraction during the 1963 slack season was unusually large, indicating a slow-down of investment activity. Besides, anticipating larger requirements for crop finance the Bank liberalized its system of lending rates and borrowing quotas in October 1963. The permissible quota for borrowings by scheduled banks, both against bills and government securities, was raised from 100 to 150 per cent of their average statutory reserves, with banks being allowed to borrow half this quota at the Bank rate (of 4.5 per cent) and the other half at 6 per cent. As the 1963–64 busy season progressed, however, it became apparent that the output of agricultural commodities was lower than earlier anticipated, and commodity prices came under renewed pressure. Credit, mainly assisted by increased recourse to the Reserve Bank, rose rapidly and the Bank felt obliged in March 1964 to formally revert to the accommodation regime prevailing prior to October 1963. However the Bank appears to have failed to sustain this restrictive stance over the next few weeks: for in nearly every case the cut in banks' borrowing quotas was restored subsequently in the form of 'special accommodation', with the result there was hardly any decline in the effective borrowing quotas of banks after March.

The year 1964 was a testing one for the Indian economic policy apparatus, not least for the Bank. The imbalance between aggregate demand and overall supplies led to prices rising sharply. Foodgrain prices, in particular, went up by more than a quarter. Given the nature of the underlying problem, policy came to focus largely on supply management through intensified procurement, larger imports, and better distribution. But during the twelve months ending 11 September 1964, money supply expanded by Rs 387 crores or some 11 per cent. While the government's rising indebtedness to the banking system was an important factor, bank credit to the private sector was also a major source of expansion, rising during the 1963–64 peak season by an unprecedented 26 per cent or about Rs 380 crores. Credit contraction in the following slack season was also only about a third of the earlier expansion. In the Bank's view this pointed to the importance of managing demand, particularly for inventories. On the fiscal front demand management called for holding down the level of deficit financing, while the task facing monetary policy was to deploy general and selective measures to restrain credit expansion to levels warranted by the productive requirements of the economy.

THE NEW CREDIT POLICY

Against this setting, the Bank effected a major revision of credit policy and its apparatus of control on the eve of the 1964–65 busy season comparable in scope and significance to the inauguration of the new monetary policy in 1951. As part of the new policy the Bank rate was put up from the existing 4.5 per cent to 5 per cent on 25 September 1964. The Bank also imposed restrictions on the inflow of banking capital from abroad which it felt might otherwise open the 'sluice-gates of expansion'. By far the more important change, however, was effected in the accommodation regime. The quota-slab system, where availability of credit was the key control variable, was discontinued and in its place was introduced a regime based on a new concept, the net liquidity ratio (NLR).

The new accommodation regime was the result of the Bank's search for a simpler and less discretionary form of central bank control over the expansion of commercial bank credit than the existing quota-slab system. Although other weapons of control too had much to commend them, the Bank's officials quickly rejected them as impractical. Higher reserve requirements were considered, only to be ruled out as being too blunt an instrument to meet the needs of a busy season credit policy particularly when banks' resources were already being strained to meet the enhanced statutory liquidity requirements which came into force from 16 September. A 'stiff increase in the Bank rate' of 1.5 per cent to 2 per cent, the Governor, P.C. Bhattacharyya, in particular felt, would have a 'salutary effect by enforcing the discipline of higher rates on the entire market structure'. But this was not possible because of 'budgetary interest cost considerations'. The Bank rate had also ceased to be a flexible instrument, its link with the 'operating rates' of the public sector and of local bodies having imparted to it a 'certain rigidity ... as an instrument of monetary policy'. The only practical course lay therefore in 'effectively raising the rate structure (in effect for the private sector)' with no more than a 'slight upward adjustment in bond yields'. Credit control, the Bank also concluded, should hence 'operate as it has done in the last two or three years on the access rights of banks to the Reserve Bank'. However it was not sufficient to restrict banks' access to central bank accommodation in order merely to make credit tighter, as this drove borrowers to seek non-bank sources of finance and helped restrict the 'area of effective central banking control'. It was also necessary to make credit dearer to ensure that there was an across the board increase in the interest rates facing the private sector.

Three formulas for regulating banks' access rights and the cost of central bank accommodation were aired in a note by M. Narasimham which formed

P. C. Bhattacharyya, Governor, 1962–67

the basis for discussions within the Bank about the 1964–65 busy season credit policy. The first was to adopt a system of differential lending rates under which the Bank would lend at the Bank rate against export bills, 'genuine internal bills of exchange', and government securities, and at half to one percentage point above this rate against bills under the bill market scheme. This idea did not make any headway: while the difficulty of distinguishing between genuine bills and 'created' bills might open the door to discretionary lending policies, officials at the Bank were also reluctant to be seen treating government securities with such 'undue preference'.

The second proposal involved fixing a credit–deposit ratio norm for banks and relating the Reserve Bank's lending rate to the margin by which the borrowing bank's credit–deposit ratio exceeded this norm. Deposits comprised nearly 90 per cent of aggregate demand and time liabilities of banks, and the credit–deposit ratio was 'effectively, though not exactly, the obverse of the liquidity ratio'. Besides encouraging them to mobilize deposits, the credit-deposit norm would also be more effective than a credit–*liabilities* norm in

discouraging banks from 'obtaining funds through inter-bank borrowings' to expand credit.

Therefore, according to Narasimham, this norm offered 'as rational a basis' as the liquidity ratio (which was the third formula and is described below) for regulating Reserve Bank lending, and had the 'further advantage of simplicity'. But with Bhattacharyya himself appearing to have preferred the third formula, the Bank adopted the concept of a 'net liquidity ratio' (NLR) as the basis of its accommodation policy.

Almost as 'cumbersome' to implement as the quota-slab scheme, this formula envisaged using a variant of the statutory liquidity ratio (SLR) to regulate the cost of the Bank's loans to scheduled commercial banks. Under the new method of accommodation which came into effect from 25 September 1964, the rate at which the Reserve Bank lent to a commercial bank depended on its net liquidity ratio. 'Net liquidity' represented the proportion of a bank's cash, balances with the Reserve Bank, current account deposits in other notified banks, and investments in Government and other approved securities, *less* its *total* borrowings from the Reserve Bank of India, the State Bank of India, and the Industrial Development Bank of India, to its aggregate demand and time liabilities.[1] In the scheme as it was originally introduced, a bank could obtain advances at the Bank rate so long as its net liquidity was at or above 28 per cent of its total demand and time liabilities.

At 28 per cent, the NLR nominally equalled the prevailing overall liquidity ratio (i.e. SLR plus the cash reserve ratio). But it represented a more stringent liquidity norm and a better index of a bank's liquidity position than the latter. While the cash reserve ratio remained unchanged at 3 per cent during the remaining years of our period, the SLR netted out only encumbered government and other approved securities. Thus, in principle, a bank could continue to borrow from the Reserve Bank against other assets and under the bill market scheme to replenish its resources, without breaching this statutory norm. In fact, a commercial bank might even finance its SLR obligations with funds it thus obtained from the Reserve Bank, by using them to buy government and other approved securities!

The net liquidity ratio, on the other hand, netted out *all* borrowings of a bank from the designated institutions. Under the proposed accommodation regime, the rate on a bank's *entire* borrowings would be stepped up by half a percentage point for every impairment of one per cent in its net liquidity

[1] This was the definition that came into force in December 1964. The original definition of net liquid assets adopted in September excluded 'other approved securities' on the assets side and borrowings from the Industrial Development Bank of India on the liabilities side.

ratio. Thus the scope for price rationing credit was now much wider, and by progressively increasing the cost of its credit, the Bank hoped to induce economy in the use of its facilities. The Bank also decided to cap the rates which foreign banks and the larger Indian banks (with demand and time liabilities of Rs 50 crores or more) could charge their borrowers at 9 per cent, so that they could not afford to borrow from the Reserve Bank at rates of more than about 8 per cent. This corresponded at that time to a lower bound for the net liquidity ratio of 22 per cent.

In a complementary move which reflected, perhaps for the first time, the integrated operation of credit and exchange control policies, the Reserve Bank also decided to place restrictions on the volume of funds foreign banks were allowed to bring in from their head offices, other branches, and correspondents, without its prior approval. This measure became effective from December 1964. Exchange banks preferred importing funds from their head offices to borrowing from the Reserve Bank to finance their credit expansion during the busy season, and the object of this move was to fortify the new accommodation regime besides ensuring that the latter did not unfairly discriminate against Indian banks.

Explaining the credit control initiative of September 1964 to heads of scheduled banks, the Governor drew their attention to the steady build-up of inflation in the economy and the large expansion of credit, not only to the government, but also to the private sector.

> As we approach another busy season which will add further pressures on the system, there is imperative need for continuing a policy of monetary restraint. At the same time, the Reserve Bank is aware that with ... credit levels being as high as they are now and with the enhanced liquidity requirements now in force, banks might find it difficult to finance seasonal needs out of their own resources and that the reliance ... on the Reserve Bank would consequently increase. If genuine seasonal requirements are to be met within the framework of a policy of credit restraint, a modification of the existing system of control is indicated which would place primary emphasis on increasing the cost rather than directly restricting the availability of accommodation from the Reserve Bank.

As noted above, the announcement of the new accommodation regime coincided with the imposition of higher statutory liquidity requirements. The former also helped reinforce the impact of the statutory liquidity requirement on the market for government securities, since it would tend to favour banks

which held a larger proportion of their assets in the form of investments in these assets. But not, in the Bank's judgement, indefensibly so, since the lower rate charged on its loans to a bank with the higher liquidity ratio could be justified as a form of compensation to this 'comparatively underlent' institution for having 'sacrifice[d] ... [its] earning power'.

An accommodation regime based on net liquidity ratios also held a number of other advantages over the quota-slab system. While access to accommodation was not restricted, the new regime placed greater emphasis, as noted above, on the cost of credit. It also made credit dearer rather than merely tighter. Secondly, unlike the quota-slab system which did not differentiate between banks with high credit ratios and those with low, banks with overextended portfolios would find it difficult to expand credit except at an exorbitant cost to themselves. In this sense, the system brought interest rates more into play; or, as Bhattacharyya pointed out, it was a form of 'credit rationing by the purse'. Under this regime banks would be paying different rates of interest on their borrowings from the Bank and those with overextended loan portfolios would find that the only low-cost option open to them lay in expanding their deposit base. This could also be expected to have positive implications for the development of the banking system. Thanks to the inhibiting cost factor, moreover, recourse to central bank accommodation could also be expected to be temporary and of a revolving character. Finally, by providing refinance outside it for specific uses of credit, the Bank could also use the new regime to develop a positive instrument of selective credit control. Thus from its inception, export bills were rediscounted at the Bank rate while from November 1965 onwards, similar favourable treatment was extended to credit to finance food procurement and defence supplies.

Though the new accommodation regime was not as effective as hoped in its first busy season, there was a deceptive sense of success until the early days of 1965. Total scheduled bank credit during the busy season up to 8 January 1965 was, at Rs 155 crores, lower by Rs 21 crores than the corresponding figure for the previous year. This was, at any rate for the Bank, a redeeming feature in a situation where the price level was substantially higher than that prevailing a year earlier. But disaggregated data showed that while the exchange banks and the other major Indian banks increased their advances by less than they had done in the last season, the State Bank of India and its subsidiaries expanded credit faster than before; with the result, the latter institutions now came to account for over half the total increase in credit during this part of the 1964–65 busy season as against merely a third in the preceding one. These credit trends were reflected in the distribution of banks' demand for accommodation from the Reserve Bank. Busy season

Bank accommodation up to the first week of January 1965 totalled about Rs 88 crores. This was lower than the aggregate accommodation banks could draw on at the Bank rate but considerably in excess of what they had obtained during the corresponding period of the last busy season (Rs 31 crores). But nearly three-quarters of the higher amount were made up of borrowings by the State Bank of India which had barely sought any accommodation from the Bank at the same stage of the 1963–64 busy season. As for the other scheduled banks, their borrowings from the Reserve Bank were down to Rs 20 crores, from Rs 30 crores during the previous season.

Though more dramatic perhaps than the Bank anticipated, the differential growth of bank credit and of recourse to Bank accommodation owed directly to the new credit policy whose object it was to make it difficult for overextended banks to extend credit except at penal rates of interest. Banks with a tight net liquidity position (the Bank of Baroda, the Bank of India, and the Canara Bank for example) experienced low growth while the overextended exchange banks saw an actual decline in their outstanding credit. In contrast, the Central Bank of India, the Punjab National Bank, the Union Bank, and the State Bank of India increased their borrowings from the Reserve Bank in the new regime. Of the four, the increases in the case of the three private banks were quite small and they soon entered the penal zone. The State Bank of India posed the more formidable challenge to the restrictive character of the new policy. Despite a fall in its deposits, the State Bank had a favourable net liquidity position. Besides, this bank had comparatively large holdings of government securities which it could afford to run down without seriously endangering its liquidity position. Thus the bank shed gilt-edged stock to the tune of Rs 74 crores by 8 January 1965, as against about half that amount at the corresponding stage of the previous season.

There were a number of factors operating on the demand side as well. The State Bank faced demands from borrowers who were denied credit by their customary bankers many of whom did not have additional resources to lend. Credit limits already sanctioned by the State Bank too were being more fully utilized than in the past, while the depression in the capital market led to greater demand for credit from the banking system. But it also transpired that the subsidiary banks, if not always the State Bank of India, were in the habit of placing their money for a month or more in the inter-bank call money market, thereby contributing to easing its condition and enabling liquidity-starved banks to borrow in that market. Officials at the Bank believed it was in the 'nature of things for an economic mechanism to resist controls' and that some follow-up action was needed to make the new regime more effective.

The follow-up action was twofold. In the first place the Bank began leaning on the State Bank of India to reduce its borrowings from it. This effort met with mixed success. While the bank reduced its outstanding borrowings on at least two occasions in response to the Reserve Bank's advice, they began rising again soon afterwards, peaking at Rs 91 crores during March 1965. Officials at the Bank were even willing to swallow their own earlier argument that the new regime was intended to make credit dearer rather than tighter, and consider laying down an absolute limit for the State Bank's borrowings from the Reserve Bank so that it would be forced to 'discipline itself to the requirements of [a] stricter monetary policy'. But such a step was not eventually taken since the bank's net liquidity ratio soon approached the penal zone and it began winding down its borrowings. But with the Bank setting itself a stiff contraction target for the ensuing slack season, the State Bank was once again asked towards the middle of April to reduce its outstandings from the prevailing level of Rs 77 crores to Rs 50 crores by the end of the month, and to Rs 25 crores by the middle of May. The State Bank heeded the Bank's advice, but only after it was backed by a letter from the Finance Ministry conveying the same message.

The more general follow-up action was taken in February 1965, but it is useful first to set it against the background of the Bank's thinking at the time. The monetary and credit situation generated a number of mixed signals to the Bank. On the one hand monetary expansion during the fiscal year up to the end of January was lower (at Rs 188 crores) than during the preceding year (Rs 322 crores). Net credit to the government too was lower than in the preceding fiscal year, as was the expansion of bank credit to the private sector during what had elapsed of the busy season. But prices began rising even in the peak season, the index rising from 155.6 at the end of November 1964 to 161 on 9 January 1965, slipping back to 160.2 a week later. Even at these lower levels prices were higher by some 17 per cent compared to the previous year. There were other reasons too for the Bank to incline towards a gloomy view of the situation. Moderate as it had been so far, monetary and credit expansion during the current season came on top of steep increases in money supply in the two preceding years and the lower credit contraction that took place during the 1964 slack season. Commodity arrivals in the terminal markets were also lower than anticipated. The onset of the current busy season, besides, was delayed until December and market reports suggested that the bulk of the financing of goods such as cotton and oilseeds was yet to take place. Hence despite the favourable initial situation, there was reason to expect credit expansion during the current season to approach the previous year's record of Rs 377 crores or fall short of it, at best, by about Rs 25 crores. If the projected trends were allowed to be realized, the Bank apprehended, money

supply in April 1965 would exceed the peak level of the previous year (reached in April) by nearly 10 per cent. Against this background the Bank wished to 'restrict ... net bank credit to both government and the private sector [and] ... minimize the rate of expansion of money supply in the rest of the busy season'. Keeping the rise in bank credit down to Rs 300 crores was regarded as a realistic target below which 'production at important points' would be hampered. Bank lending to government during the rest of the busy season was also proposed to be restricted to Rs 25 crores. These targets, according to an internal Bank note, were consistent with a rise of about 7.2 per cent in money supply over the previous April peak.

To achieve this target however, the existing restrictive policy had to be reinforced. The major policy change was an increase in the Bank rate from 5 per cent to 6 per cent on 17 February 1965. This increase was indicated by other factors as well, including the foreign exchange position, the rise in the Bank of England rediscount rate to 7 per cent in November 1964, and approaching negotiations with the Fund for another standby arrangement. Although thanks to controls, the London Bank rate did not affect the Indian capital account directly, particularly after restrictions were imposed on the flows of banking funds, the wider spread between interest rates in India and London was believed to be delaying the remittance home of export receipts. In fact, Bhattacharyya who had for some months past been favouring a policy of dearer money, would have liked to put the rate up to the 7 per cent prevailing in London, but in the end the Bank balked at a jump of two points. A rise in the rate of even a full percentage point was unprecedented, earlier changes in the Bank's three decade long history until then having been of the order of half a per cent.

Other restrictive measures were adopted at the same time as the Bank rate was put up. The minimum net liquidity requirement for borrowing at the Bank rate was raised to 30 per cent and the cap on the advances rate of the larger banks (and foreign banks) was raised to 10 per cent from the prevailing 9 per cent. The Bank also decided to abstain from open-market operations until the pattern of yields had adjusted to the current structure of interest rates in the market. These measures were however largely ineffective for their intended purpose. After a delayed start the peak season picked up momentum rapidly and despite the more stringent accommodation regime, scheduled bank credit expanded by Rs 407 crores during the season. This represented the highest absolute increase in bank credit during a single season, but even the relative increase was at 24 per cent only slightly lower than the increase of 26 per cent recorded during the previous busy season.

MONETARY POLICY, 1965–67

Expansion of such magnitude in the busy season lent urgency to securing the orderly retrenchment of credit during the slack season. In addition, discussions within the Bank over slack season policy took place against the background of the standby agreement between the Government of India and the International Monetary Fund. Although the agreement itself was not finalized until March 1965, its intimations and those of the weak foreign exchange position it was intended to address were already discernible in the monetary policy announcements of February 1965. The standby agreement set a ceiling of Rs 3,044 crores for the Reserve Bank's net domestic assets in July 1965, and thereafter Rs 2,988 crores up to February 1966. (Holdings of these assets stood at Rs 2,819 crores in February 1965.)[2] The Bank had also indicated to the Fund its plans to reduce bank credit during the 1965 slack season by about Rs 200 crores.

There were, needless to stress, two aspects to not breaching the Fund ceiling. Net Bank credit to the government would depend largely on the 'behaviour of ad hoc treasury bills'. But the Bank itself could so conduct open-market operations as to reduce or postpone additions to its net domestic assets. Bank credit to the private sector was the second element in the situation. Thanks to faster than expected growth in bank credit and large issues of ad hoc treasury bills, the Fund ceiling was in danger of being breached even before the current busy season drew to a close. At the same time, foreign exchange reserves were declining rapidly and it seemed only a matter of time before they dropped below the legal minimum. Hence the government decided towards the third week of April to draw a portion of the standby credit. By going in for an early drawing the government also hoped to avoid having to engage the Fund in protracted consultations after the domestic assets ceiling was breached. This move was preceded by the letter from the Finance Ministry to the State Bank of India referred to above, to reduce its outstanding borrowings with the Bank by at least Rs 30 crores.

Given the large expansion of credit during the 1964–65 busy season, the Bank initially set its sights on securing as high a contraction of credit during

[2] According to the standby agreement, net domestic assets of the Reserve Bank included the domestic assets of the Issue Department, assets held in the Banking Department such as internal trade and government treasury bills purchased and discounted, investments, loans and advances to governments and banks, investments, loans, and advances made from the Bank's Long-term Operations Funds and Stabilization Fund, less liabilities (of the Banking Department) such as governments' deposits.

the 1965 slack season as possible. Apart from being desirable in itself, any realistic prospect of the Bank adhering to the Fund ceiling in the next busy season also depended on reducing bank credit substantially during the slack season: once the level of credit outstanding at the end of the slack season (or the outset of the next peak season) was sufficiently low, more realistic credit expansion targets could be set for the busy season up to February 1966. This was partly the reasoning behind the Bank's advice to the State Bank to reduce its borrowings from it by the middle of May. Credit contraction during the slack season was usually about half to 60 per cent of the expansion in the preceding busy one. In some years, as in 1964, the proportion fell away to 34 per cent, while in 1963 it was as high as 64 per cent. Against this background, the Bank believed a contraction of Rs 175 crores realistically possible in the 1965 slack season. The large size of Bank accommodation during the busy season, sizeable bank advances against seasonal commodities (62 per cent as opposed to 49 per cent in the previous busy season), and improved supply outlook for the latter were seen as propitious omens. On the other hand, the desire of traders and others to restore stocks they had run down during the previous summer threatened to increase the slack season demand for credit, while a major imponderable on the supply side was the rise in the deposits of the banking system which typically took place during this season as a result largely of the government's deficit financing operations and delayed export receipts. If bank deposits grew at a healthy rate, banks would be enabled to pay off their debts to the Bank and even raise their investments in government paper should they be disposed to do so, without contracting advances to any appreciable extent.

The thinking within the Bank in May 1965 was that deposits could be expected to rise by about Rs 200 crores during the slack season. Officials believed it would be possible to reduce outstanding bank credit by Rs 120 crores without any significant tightening of policy, and that contraction beyond this depended on the measures taken. But there was little sign, as the slack season progressed, of any substantial reduction in bank credit: during the six weeks ending June 11, for example, bank credit fell by only about Rs 25 crores in contrast to a decline of over Rs 35 crores during the corresponding part of the previous year. Apart from the persistent demand for credit from those who wished to restore their stocks, it also appeared that banks with tight liquidity positions had phased their non-seasonal advances to the slack season. To officials at the Bank, this indicated the need for a further tightening of policy.

Three policy measures were aired in internal discussions. The first was to raise the cash reserve ratio from the existing 3 per cent to 4 or 5 per cent.

On a deposit base of Rs 2,600 crores this was expected to lead to reserves of Rs 26 crores or Rs 52 crores being impounded. The advantage with variable reserves was that of the three instruments considered, this alone possessed an automatic sanction against non-compliance. There were however two problems here. First, for a moderately higher reserve ratio to exert an additional contractionary influence on bank credit, its imposition would have to be deferred until the normal slack season contraction had taken place since otherwise the latter could be set off against the higher reserve requirement. This meant waiting until August at least. Another argument against higher reserve requirements was that they might actually worsen the net domestic assets position should banks, for example, feel encouraged by their improved liquidity position to step up their borrowings from the Reserve Bank. In contrast two other instruments were together thought to offer greater promise of contracting credit in the slack season and preventing an increase in the Bank's net domestic assets.

The first of these was for the government to issue treasury bills or treasury deposit receipts, with the Bank offering them on tap to scheduled banks. This proposal emerged partly out of the Bank's concern that the market for treasury bills was often inactive even in the slack season, with banks preferring to park their surplus balances in the inter-bank call money market although it might sometimes offer a lower yield than treasury bills. The Governor raised this concern in May 1965 at a meeting with bankers called to underline the importance of adequate credit contraction in the slack season. Apart from expectations, bankers believed the tender system of offering treasury bills made for low yields during the slack season, while another disincentive was the non-availability of treasury bills throughout the week. There were also doubts in the market over whether the Bank itself favoured frequent investments and disinvestments in treasury bills.

The Bank therefore began examining ways of making the treasury bill a more attractive instrument of short-term investment to banks. Although there was some scepticism as to how much of the funds invested in the call money market could be diverted towards treasury bills, there was general agreement that this proportion should be increased to the maximum extent possible. One method considered was to offer the asset on tap through the week with yields ranging between 2.5 and 4.5 per cent depending on conditions in the call money market. But the latter might vary beyond this range of yields so that an alternative method of allowing the market to freely determine the yields, was also considered. In the end the former method was preferred as representing the less radical departure, and it was decided to fix the week's treasury bill rates each Monday on the basis of call money conditions during the preceding week.

The formal decision to inaugurate the supply of treasury bills on tap was taken early in June and the yield during the first week fixed, at the Governor's initiative, at a generous 3.5 per cent. The immediate response of banks to this new investment opportunity was none too enthusiastic, so that initially the Bank considered adding 'an element of compulsion' by directing commercial banks to invest a specified percentage of their deposits in treasury deposit receipts. Modelled on British wartime assets of the same name, officials expected this move to curb private sector credit in a way which was meaningful from the point of view of the standby agreement if some other means could also be deployed simultaneously to prevent banks from translating their improved liquidity positions into higher borrowings from the Bank. Hence the second suggestion which was for the Bank to prescribe a minimum reduction in banks' peak season credit so that they restored a given credit–deposit ratio or reduced their outstanding credit to some proportion of the seasonal peak.

Despite these detailed exercises the Bank 'refrained from adopting any quantitative measures designed to bring about a credit reduction' during the 1965 slack season. The only credit control measures taken during the season were of a selective nature. Banks were directed on 29 June to keep their unsecured advances at or below the level prevailing on 25 June 1965. The Bank also required importers to maintain advance deposits with banks of a quarter of the value of goods shipped, and banks to invest such deposits in treasury bills. Besides, commodity-specific controls were imposed on lending against paddy and rice, wheat, other foodgrains, groundnuts and other oilseeds, vegetable oils, and cotton and kapas.

The Bank also advised scheduled banks to increase investments in treasury bills. When this evoked no response—fewer treasury bills were sold in June 1965 than in the same month of the previous year—the Governor called another meeting of their chief executives on 21 June where the same point was made more forcefully and with rather greater success. As the peak season drew to a belated close and banks also grew used to their availability on tap, sales of treasury bills went up sharply from Rs 26.5 crores in June 1965 to Rs 142.8 crores in July. (The corresponding figures for the previous year had been Rs 32.4 crores and Rs 47 crores respectively.) With sales of treasury bills remaining high in the subsequent months as well, scheduled banks' outstanding investments in these instruments rose from Rs 5.31 crores at the end of March 1965 to Rs 20.1 crores at the end of March 1966. Thanks to the success of the new system of tap sales of 91-day treasury bills, the Bank also began to consider offering six month treasury bills on tap 'as a convenient instrument for banks to hold during the slack season....'

Tap sales helped expand the market for treasury bills, but did little immediately to help contract credit in the slack season. The total contraction effected up to August 1965 was a mere Rs 87 crores, against Rs 111 crores on a lower credit base in the last slack season. By now, of course, a contraction of Rs 125 crores seemed optimistic, let alone the Rs 175 crores the Bank had originally trained its sights on. Even the directive of 29 June against clean advances had to be modified as it led to an 'uproar', particularly 'from a number of small borrowers'. The Finance Minister, T.T. Krishnamachari, too opposed the directive, insisting that it would hurt industry most. Rejecting the Bank's argument that banks in any case did not lend substantial amounts to industry because they preferred to keep their resources free for the busy season and refusing to concede that any other course would make it impossible for the government to fulfil its commitment to the Fund, he directed the Bank, somewhat peremptorily from Washington, to modify its directive on clean advances.

By August 1965, however, the Bank's assessment of the credit expansion experienced during the previous busy season too had become rather more positive. Though higher than ever before at Rs 407 crores, credit expansion during the past busy season, officials at the Bank now felt, was not excessive in relation to the 'real level of transactions financed by the banking system'. Nor had the credit expansion proved inflationary. In October 1964 prices were nearly 15 per cent higher than those prevailing a year earlier. In April 1965, however, prices were only about 10 per cent higher. Despite the rapid increase in bank credit and in lending by the Bank, the market had remained tight. Inter-bank rates touched 10 per cent both in Calcutta and in Bombay which was unprecedented, while the unorganized market reported rates of 18 to 20 per cent. The weighted average rate on borrowings from the Reserve Bank reached 8.44 per cent on May 14, compared to the previous season's peak of 5.62 per cent on 27 March 1964. Thus, 'the absolute figures of credit expansion' did not, in the Bank's present view, 'reveal sufficiently the tightness of the rein on credit'. It would also be 'facile' besides, officials now argued, to 'interpret the large absolute level of expansion as signifying the ineffectiveness of the squeeze'.

This re-evaluation of credit developments in the previous busy season also put the current slack season in a somewhat different light. According to the new view, it was no longer possible to ignore the special factors which made the return flow of funds less smooth than normally. Despite large exports, the record production of sugar during the year left stocks to be carried until the beginning of the new sugar year. The government's buffer-stocking operations in foodgrains could also be expected to come in the way of a full return flow

of funds. Besides, textile stocks had accumulated with mills, while soyabean oil imports had been deferred to the summer because of difficulties in obtaining credit during the busy season. Although direct action on the reserve base through calling up additional reserves or issuing treasury deposit receipts was still mooted, there was not the same urgency about such measures as previously. Moreover, the imminence of state government loans meant that recourse could not be had immediately to these instruments. In the event, credit contraction in the 1965 slack season was only Rs 93 crores. This was less than a quarter of the credit expansion witnessed during the preceding busy season and less than half the contraction the Bank had hoped to see.

Discussions over the busy season policy for 1965–66 commenced against this background. The initial anticipation was that the expansion of scheduled bank credit during the season would be about Rs 425 crores, financed by fresh deposits (Rs 110 crores), disinvestment in government securities (Rs 170 crores), and central bank accommodation (Rs 145 crores). With credit expansion of this magnitude, the Fund's ceiling on the Bank's net domestic assets would come under pressure from December. Hence while permitting credit to 'expand up to the requirements of the economy', measures to check excessive expansion by tightening some existing instruments of control were also mooted. Bafflingly in the circumstances, some officials also proposed persisting with controls over the inflow of banking capital, advancing in their defence the same reasoning offered a year ago, namely that it might otherwise become 'the sluice-gates for credit expansion'.

Although counselling a general policy of restriction, economists at the Bank were overcome by a discernible 'tightness fatigue', with a note by M. Narasimham, which otherwise advocated a tight rein on credit, insisting that if the

> level of transactions were even slightly above that of the last busy season, it would seem necessary to provide for this expansion ... even if it should mean piercing the net domestic assets ceiling, as the alternative to this would mean a squeeze so severe as to hamper economic activity.

This fatigue was more marked in V.G. Pendharkar's somewhat despairing note which questioned whether any link existed between credit policy and prices in the peak season. The latter, Pendharkar argued, were largely influenced by seasonal factors outside the control of the banking system. To suggest that an effective credit policy prevented matters from getting worse amounted to conceding that general credit policy instruments had no role other than supporting selective control measures. With the effects of monetary policy

being so indistinct in the peak season, Pendharkar wondered whether a 'tighter policy' was worth the price of lower investment and a further depression in the capital market:

> A time when industrial production is likely to be decelerating and the capital market is in a depressed state is certainly not the time for tightening monetary policy. The capital market ... needs to be lifted out of the morass it has got bogged in. This argues for a reflationary policy.

Suggesting a monetary policy which besides exerting a 'favourable balance of payments impact' would not 'adversely affect the internal price situation', Pendharkar recommended relaxing controls over the inflow of foreign banking funds into India. He also wanted selective controls used more freely, some check on the rise in clean advances, and monetary policy concessions to boost industry and the capital market. Finally, Pendharkar counselled against raising the existing net liquidity ratio norm and any sharp escalation in the Bank's accommodation rates.

Independently, Krishnamachari echoed Pendharkar's scepticism about the impact of monetary policy on prices. Remarking in a letter to Bhattacharyya written in September 1965 that the 'beneficiary effect of monetary policies on prices was very very faint', the minister suggested that policies framed with an eye to the Fund undertaking had resulted in acute stringency in the market, 'stifled business ... and dampened an already slack share market'.

As it happened, credit policy in the early part of the 1965–66 busy season came to be dominated by the hostilities which broke out with Pakistan in September 1965. Considerations such as the size of the Bank's domestic assets consequently took a backseat. Monetary policy, it was now felt, should aim to preserve a 'reasonable balance between aggregate monetary flows and the availability of real goods and services', besides 'helping to bring about ... a diversion of resources' to defence-related sectors. While increasing the cost of accommodation for banks breaching the net liquidity ratio norm and relaxing (largely for balance of payments reasons) controls on inflows of banking capital imposed less than a year earlier, the Bank advanced schemes to refinance credit extended to the defence and exports sectors and make pre-production finance available to defence-related industries. Foodgrains procurement was the other area of preferential refinancing. While refinancing banks' advances to these preferred sectors liberally at the Bank rate, the Reserve Bank also decided to set such refinance off against banks' net liquidity ratios so that their other advances might be squeezed. In addition, selective controls were tightened for advances against foodgrains, oilseeds, and vegetable oils.

By the time the Governor joined issue with the Finance Minister in December 1965 over his views on the effectiveness of monetary policy, the emergency had passed. Bhattacharyya agreed with Krishnamachari that demands on bank credit had multiplied following the growth of the economy, the increase in sugar, foodgrains, and textile stocks, the depression in the capital market, and the virtual collapse of the unorganized credit market, in particular the operations of Multani *shroffs*. On the other hand, there was justified anxiety that bank credit which found its way into some of these sectors might not return to the banking system and that the latter would be able to expand credit only by being 'fed continually throughout the year by the Reserve Bank'. While the Bank had a responsibility to provide seasonal finance, non-seasonal finance Bhattacharyya underlined, should be met by the banks themselves out of their own resources:

> If the banking system were to be fed by [the] ... Bank ... throughout the year, it would only add to the monetary pressure on the economy which is already suffering from the ... heavy deficits incurred by the Government ....

Explaining the current policy of checking banks' borrowing to meet non-seasonal needs, reducing the volume and duration of those to meet seasonal needs, and capping the interest rate on bank lending, Bhattacharyya argued that the 'very faint' impact of credit policy on prices was no reason to cheapen credit or increase banks' access to central bank accommodation. Nor was it possible to administer selective controls within an overall credit policy that was too liberal.

> I fully share your view that conventional methods of monetary policy do not apply with the same force in our economy as in the western ones and that some measure of improvisation is needed all the time in order to achieve the ends we have in view .... But I would strongly urge on you that this is not the time when credit should either be cheapened or made more freely available generally. We have to wait to see that the economy is geared to a condition where increased production possibilities are apparent before we make any change in the monetary policy.

The 1965–66 peak season also saw the introduction of the Credit Authorization Scheme in November 1965. It was born of a suggestion TTK and Asoka Mehta (Deputy Chairman, Planning Commission) made to Bhattacharyya, to formulate ways in which to align credit policies more closely with the five-year plan. The French success in integrating credit allocation

with their system of indicative planning appeared to offer some promise in this regard, and this scheme was one of the several suggestions considered following its author Narasimham's study of the French experience. Under this scheme, scheduled commercial banks were required to obtain the Bank's authorization before sanctioning any fresh credit of Rs one crore or more to any one borrower, or any fresh limit which would take the total limits enjoyed by the borrower from the entire banking system to Rs one crore. Existing limits were however not affected. During the first two years of its operations, the Bank authorized additional limits totalling Rs 1,000 crores. The total authorized limit amounted to about Rs 3,080 crores at the end of December 1967. Rejections were few, with 2,255 approvals out of 2,330 applications. While 80 per cent of the authorized credit limits were for working capital purposes, purchase and discount of bills accounted for 8 per cent and term loans for 6 per cent. Limits for financing exports and sale of machinery increased in the first two years of the scheme from 3 per cent to 6 per cent.

The objective of the scheme was to bring credit operations into line with established national priorities. The main criteria used for examining applications for enhanced limits were the purpose of the advance in relation to the plan, the productive nature of the activity expected to be financed, and the optimum level of inventories. The scheme also helped prevent a few large borrowers from pre-empting scarce bank resources and in enforcing a measure of financial discipline upon them. The former consideration began to grow in importance as the authorities in Bombay and Delhi became sensitive to the impact of credit rationing on smaller borrowers: the protests that greeted the restriction of clean advances in June 1965 appears to have emanated largely from this segment, and meeting its credit requirements would become, increasingly in the future, an important object of credit policy.

Despite additional defence expenditures, the 1965–66 busy season did not witness a boom in bank credit, the latter expanding by only Rs 310 crores during these months. However, money supply rose by Rs 486 crores (or nearly Rs 100 crores more than the increase registered in the preceding peak season) principally because of the Bank's large net credit to government which amounted to Rs 387 crores during the 1965–66 busy season (as against Rs 160 crores in the 1964–65 busy season). Occurring at a time of a severe shortfall in the availability both of domestic goods and imports, the Bank apprehended that the government's large expenditures would inject considerable excess liquidity into the banking system. The normal contraction of credit during the 1966 slack season was expected to add Rs 75–100 crores, and deposits Rs 200 crores to banks' resources during these months.

As against this, banks owed some Rs 30 crores to the Reserve Bank, while existing reserve and liquidity requirements would immobilize another Rs 60 crores.

Nervous about the effects of the liquidity overhang of Rs 200 crores on credit and prices during the slack season, the Reserve Bank proposed immobilizing banks' additional deposits by calling up, in the first instance, the full increment of deposits in May 1966, and also impounding June deposits, if necessary, once more was known about the government's borrowing programme. However for reasons that are not recorded and which may well have something to do with the chorus of protests with which business and industry greeted the rupee's devaluation less than three weeks after Bhattacharyya's letter to the Finance Minister communicating this proposal, no such action was taken in the end, the Bank merely advising commercial banks to ensure adequate contraction of credit during the slack season and invest additions to their resources in treasury bills. The latter, the Bank may have rationalized, virtually amounted to voluntary impounding of deposits.

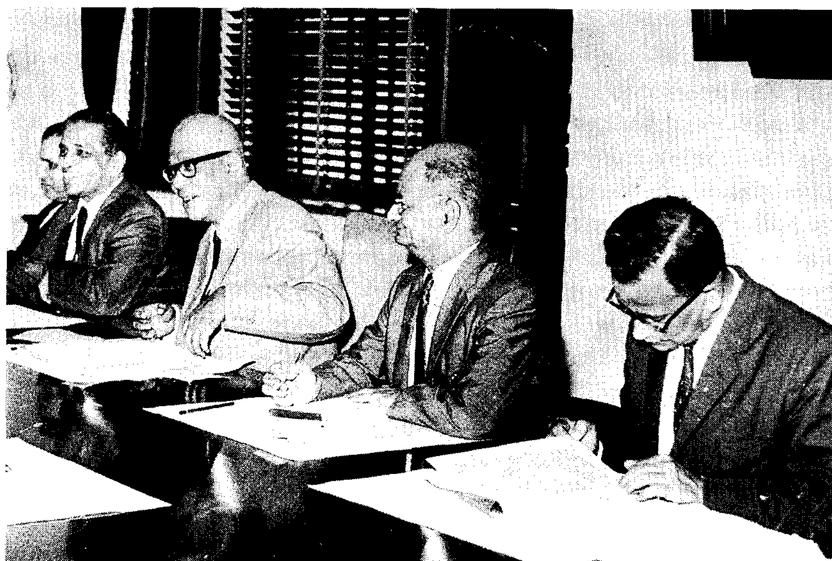
Credit contraction during the 1966 slack season amounted to Rs 86 crores, or about 28 per cent of the increase in credit during the preceding busy season. Banks' deposits however rose more than the Bank anticipated, by Rs 265 crores. But equally, their investments in government securities increased by Rs 298 crores as against less than half this amount the previous year. Consequently, the aggregate investment ratio of banks moved up smartly from 27.4 per cent to 34.3 per cent.

Credit policy during the 1966–67 busy season was framed initially in the expectation of a substantial recovery in agricultural production. Therefore the Bank allowed commercial banks to secure an additional refinance tranche at the Bank rate of 10 per cent of their net liquidity ratio at the end of the slack season. But once it became clear that there would be no recovery in foodgrains output, the Bank instructed the larger Indian banks and all foreign banks to ensure that 80 per cent of their seasonal expansion of credit was directed towards financing industry and foreign trade. Despite repeated warnings, credit expansion (about Rs 411 crores till 17 March 1967) remained, in the Bank's judgement, larger than that 'warranted by the availability of real goods' in the economy. Equally worrying was the increase in clean advances in the early part of the busy season. Therefore, at the end of March 1967 the Bank decided to implement the threat it had held out in October the previous year of charging 'really penal rates' of a minimum of 11 per cent on excess borrowing by banks whose net liquidity ratios dropped below 30 per cent. This had the intended effect, and the seasonal expansion of bank credit during

1966–67 was held down to about Rs 425 crores. After registering a sharp increase till January 1967, clean advances too dropped by April 1967 to levels below those prevailing at the onset of the busy season.

PREFERRED SECTORS AND MORAL SUASION

The concept of 'preferred' or 'priority' sector credit, which was beginning to make its appearance at this time, was intended to give a positive thrust to the Bank's credit control policies during these years. In July 1961 the Bank conducted a survey of loans granted to cooperative institutions and small-scale industries mainly in order to see how credit flows to these segments might be increased. The results of the survey showed that advances to small-scale industries at the end of June 1961 amounted to Rs 27 crores or only about 2.5 per cent of total scheduled bank credit. Advances to cooperative institutions amounted to Rs 9 crores, i.e. less than one per cent of total scheduled bank credit. With a view to giving banks an incentive to increase their lending to these two sectors, they were allowed in addition to the existing arrangements, to borrow at the Bank rate the amounts they advanced to these sectors. This arrangement which initially remained in force during the first half of 1962 was continued thereafter with some



Bhattacharyya (third from right) discussing credit policy with bankers, June 1967. Governor-designate Jha and Adarkar are to his right; Anjaria is to his left.

modifications. Besides, while access to Bank accommodation became progressively more restricted during these years, banks' lending to preferred sectors often qualified for refinance at the Bank rate. Preferred sectors varied over time, but included cooperative institutions, small-scale industries, food procurement credit, credit for financing defence production, industries producing essential goods, and exports. The availability of refinance credit for these sectors was further liberalized in January and March 1963.

The importance of agricultural credit in the Bank's priorities grew with the adoption of the new agricultural strategy. It came to the Bank's notice in May 1965 that its exhortations to banks to effect a sizeable contraction of credit during the 1965 slack season had the effect of reducing lending for agricultural development schemes under the refinancing programme of the Agricultural Refinance Corporation. The Bank had therefore to clarify that while restraint remained the guiding principle, a 'modest and desirable increase' in the provision of credit facilities for agriculture 'would not ... be inconsistent with the requirements of short-term credit policy'.

Export finance was another preferred sector, with the Bank lending against banks' promissory notes backed by export bills at lower rates of interest than under the bill market scheme. In June 1966 manufacturing industry was also classified as a priority sector. During the following busy season, the Governor directed large Indian banks and foreign banks to extend 80 per cent of their credit between the end of October 1966 and April 1967 to industry or against export and import bills. For this purpose the term 'industry' was defined broadly to include plantations, mining, transport, and power. The need to provide adequate credit to small-scale industries was also emphasized. However when credit trends during the 1966–67 busy season showed a pronounced rise in clean advances, the Bank suspected that banks were lax in reallocating credit between preferred sectors and the others. The Governor therefore took it upon himself to caution banks that Reserve Bank directives regarding the composition of their credit portfolios had the 'same binding force as any other obligation imposed by the Banking Regulation Act', and that penal action could follow if these were ignored. Allocative disputes once again came to the Bank's notice following complaints that many banks had responded to its exhortation by freezing all unutilized credit limits to the non-priority sectors. This affected trade, in particular those traders who had left some portion of their credit limits unutilized, while others who had used up their limits held on to their advantage. Demanding a change in policy, the Bank instructed banks to reduce limits pro rata, even if it meant recalling some advances, rather than freeze unutilized limits.

TOWARDS REGULATING INTEREST RATES

The greater frequency of Bank rate changes during the 1960s should not be allowed to obscure the segmentation that was taking place in the credit market during these years. In practice the Bank's credit policy aimed to increase this segmentation along several axes, notably through creating a captive market for government loans. Besides being substitutes for raising the Bank rate, both the quota-slab system and the accommodation regime based on net liquidity ratios involved differential rates of lending by the central bank and had the effect of keeping down the increase in the Bank rate needed for any given increase in the lending rate of commercial banks. But since the extent of commercial banks' dependence on its accommodation facilities (and therefore the costs to them of changes in the conditions of access to these facilities) varied, the Bank was forced to complement its access policy by regulating the interest rates banks charged on their loans. Although the issue had been discussed for several years previously, the Bank was also drawn in 1964 into regulating the deposit rates of commercial banks. While the increase in lending rates was intended to give greater teeth to its generally restrictive credit policy, the Bank regarded its efforts to rationalize the deposit rate structure as part of the wider institutional dimension of monetary policy which was beginning to find a more explicit place in its priorities at this time. As contemporary officials saw it, deposit rate regulation would encourage banks to offer more realistic and 'competitive rates of interest on deposits', boost longer-term savings, attract a larger proportion of these to the organized banking system thereby helping to 'institutionalize ... the financial and credit structure of the economy', and finally reduce banks' dependence upon the Reserve Bank for accommodation.

LENDING RATES

As we noted above, a consequence of the quota-slab system of accommodation introduced at the beginning of the 1960 peak season was the Bank's move asking commercial banks to increase their average lending rate by at least half a percentage point and maintain a minimum lending rate of one per cent above the Bank rate. This measure was necessitated by the fear that the rise in the Bank's lending rate might not affect banks that did not borrow from it, and by the need to ensure that the higher cost of borrowing was passed on to their ultimate borrowers.

Although this was the first step the Bank took towards regulating banks' lending rates directly, it had no reason to follow it up for some more time. In the meantime in January 1963, scheduled banks adopted an inter-bank

agreement on lending rates under which the minimum rate on all advances other than some specified exempt categories was fixed at 6 per cent. This yielded banks a margin of 2 per cent above the Bank rate. As it happened, the latter was put up to 4.5 per cent from 3 January, i.e. within two days of the inter-bank agreement coming into force; following which the participating banks increased their minimum lending rate to 6.5 per cent. In April 1963, the State Bank of India, which did not subscribe formally to the inter-bank agreement and which had not previously increased its lending rates, raised its general advances rate by one per cent. The long-term lending agencies also raised their lending rates by half a per cent in line with the Bank rate. Following the increase in the Bank rate to 5 per cent in September 1964, the minimum advances rate under the agreement went up to 7 per cent.

The Bank justified the increases of September 1964 (and February 1965) on the ground that the rate of interest was both an instrument for 'regulating the volume of investment and of augmenting the supply of savings'. Even though the responsiveness of investment to interest rate changes and the interest elasticity of savings were matters of dispute in India, it was generally conceded that interest rates were capable of affecting inventory investment. At least to that extent, the Bank concluded, they had a role to play in credit management especially in an inflationary environment. In the longer term the Bank envisaged the structure of interest rates also to help bring the public sector under some kind of financial discipline: the cost of capital, in its view, should be central to the evaluation of any project and the illusory cheapness of capital should not be allowed to dictate the inefficient use of scarce resources. This was however merely a shot across the government's bows which the Bank did not follow up in any sustained manner.

With the introduction of the accommodation regime based on net liquidity ratios, the Bank grew sensitive to the possibility of borrowers, whose demand for credit might remain unabated in a speculative environment, being able to absorb the higher interest charges their banks passed on to them. Hence in September 1964 it decided to impose a ceiling of 9 per cent on the rate that Indian banks with aggregate demand and time liabilities of Rs 50 crores or more and all foreign banks could charge on their advances. The immediate object of this directive was to make the Bank's tight money policy work without too great a rise in the Bank rate by squeezing the margins of commercial banks and reducing their recourse to the Bank for accommodation. The minimum advances rate under the inter-bank agreement was raised to 8 per cent following the increase in the Bank rate to 6 per cent in February 1965. Simultaneously the Bank raised the ceiling rate

on advances, overdrafts, and discounts of the larger Indian and foreign banks to 10 per cent.

Deposit Rates

While the regulation of lending rates began essentially as an ad hoc expedient, the Bank had been disposed to consider regulating the deposit rates of commercial banks for about a decade prior to its first steps in this direction in 1964. At the beginning of the period covered by this volume, the interest rate structure of commercial banks was the outcome largely of uncoordinated decisions by the major commercial banks. The Imperial Bank of India set the trend both for deposit rates and lending rates. It offered the lowest deposit rates and could afford relatively low interest rates since it dealt mainly with 'prime' borrowers. Other commercial banks fixed their interest rates in relation to those of India's premier commercial bank. From October 1958 however, deposit rates offered by commercial banks were covered by a voluntary inter-bank agreement. This lasted until the mid-1960s when the Bank began to put in place a mechanism for regulating interest rates offered and charged by commercial banks.

The genesis of the inter-bank agreement on deposit rates can be traced to the competition for deposits and the adverse effect this was feared to have on the cost of banks' funds and the quality of their loan portfolios. Already in the early 1950s, many bankers were in favour of regulating competition for deposits by means of a voluntary agreement on deposit rates. The Bank Award Commission (1955), whose report had the effect of increasing the operating expenses of banks, also favoured such an agreement with its Chairman, P.B. Gajendragadkar, expressing surprise as to 'why in their own self-interest banks belonging to particular competing groups cannot agree among themselves on the ceilings for these rates'. If such an agreement did not come about voluntarily, Gajendragadkar declared, 'it may become necessary for Government to consider whether they can regulate the deposit rates for banks'.

In 1954 the Bank had responded with notable lack of enthusiasm to a suggestion by the Indian Banks' Association to prescribe ceilings on deposit rates. The case for controlling the latter rested mainly on the unhealthy effects of escalating deposit rates on banks' operating costs. It was also apprehended that rising deposit costs gave exchange banks a competitive edge over Indian banks: not only had the latter to invest a greater proportion of their resources in low-yielding government securities during the slack season when exchange banks moved their resources overseas, they were also less able than exchange banks (which dominated the financing of India's external trade) to pass on

higher interest charges to their borrowers. However, while being of the view that 'some sort of agreement to avoid a rate war among banks' was 'desirable', the Bank remained sceptical about competing banks arriving at an agreement amongst themselves. Little consideration was given at this time to regulating interest rates through executive or legislative action since such a course 'bristled with difficulties'.

The Bank's views on regulating deposit rates hardened somewhat after the Bank Award Commission's report. There was, according to its officials, 'hardly any case for a general regulation of deposit rates'. Regulation was not necessary to ensure the 'safety of funds held by banks' since the Bank enjoyed adequate powers under existing laws to 'scrutinize' the use banks made of their funds and take action if they were found to follow 'unhealthy practices'. Rising deposit rates were also not an 'unmixed evil'. At a time when advances were rising steadily and 'some check to the process' was 'desirable', higher deposit rates 'performed the salutary function of restraining the demand for credit' through higher rates on advances. The Bank also felt there was little it could do to force banks to arrive at a voluntary agreement if they did not want one.

Members of the Indian Banks' Association too responded coldly to Gajendragadkar's suggestion for a voluntary agreement on interest rates. Competition for deposits actually intensified in the months following the report, forcing the Chairman of the State Bank of India to devote a part of his speech to the Annual General Meeting of the shareholders of his institution to calling for a halt to the tendency. Demanding steps to discourage 'unhealthy competition', he suggested that if a voluntary agreement among banks was not 'possible because of the diversity of their size and standing', the government should 'consider suitable action for regulating deposit rates'. But whatever the State Bank's intentions in airing its views on the subject so openly, neither the Bank nor the government were at this time in favour of regulating deposit rates, Finance Minister T.T. Krishnamachari telling bankers in October 1956 that they were free to raise interest rates to attract more resources and the Governor, B. Rama Rau, also affirming the Bank's disinclination to prescribe interest norms and its preference for a voluntary agreement amongst banks.

When the issue revived in April 1958 the Bank held to its earlier view that voluntary agreement offered the only basis for regulating deposit rates of banks. Later the same year 36 banks, which accounted between them for 90 per cent of the deposits of all scheduled banks with the exception of the State Bank of India, arrived at an understanding among themselves which was formalized as the All-India Inter-Bank Agreement. This agreement which came into effect from October 1958 applied to Indian banks (other than the

State Bank of India whose interest rates were in any case the lowest in the industry) with deposits of Rs 5 crores or more. Under this agreement the maximum interest rate allowed on current accounts was a quarter of one per cent. A bank could pay up to 3⅞ per cent (all per annum) on 'notice money' so long as the notice period for withdrawal was seven days or more, and up to 2.5 per cent on savings deposits. Cash certificates of three to five years' maturity were allowed 4 per cent while those of longer maturities were allowed a quarter of a percentage point more. The maximum interest on term deposits for less than three months was fixed at 3⅞ per cent while that on term deposits of longer duration was set at 4 per cent. Indian banks having deposits between Rs 5 crores and Rs 25 crores were allowed to offer a quarter of a per cent more than these rates on term deposits. The agreed rates on 'notice money' and term deposits were lowered in September 1959 and again in August 1960, so that the maximum rate of interest offered on long-term deposits was now fixed at 3.5 per cent.

The Bank's disposition to see commercial banks arriving at voluntary agreements to regulate interest rates gave way gradually to a more interventionist policy from the 1960s. Partly, of course, this change accorded with the intellectual predilections of a new generation of middle and senior-level officers of the Bank. More importantly, the Bank had earlier been diffident about regulating deposit rates in a competitive environment marked by rising deposit rates, which it felt, reflected the shortage of banking funds in relation to the demand for them. But the inter-bank agreement threatened, at least in 1960, to betray the characteristics of a cartel, more so as banks' efforts to depress deposit rates coincided with a steep decline in the rates of deposit growth. This would not become fully apparent until later, but already by August 1960 the slow-down in the growth of bank deposits had begun to give rise to some anxiety within the Bank and in the government.

Even as internal notes pondered the role of higher interest rates in restoring deposit growth, the changes made to the inter-bank agreement in August 1960 appear to have spurred the Bank into action. There were, in the Bank's view, two things wrong with the existing structure of commercial banks' deposit rates. First, commercial banks still offered relatively high rates on short-term deposits, in particular on 'notice money' which was a form of deposit that only privileged clients were allowed to own and operate. Secondly, the rate offered on longer-term deposits was too low in comparison, with the result the spread between short-term deposit rates and longer-term rates was too narrow. This, the Bank believed, could adversely affect the ability of the banking system to mobilize the savings of the community. There was a slight widening of the spread in August 1960 when the rate on shorter-term deposits was lowered

slightly (by one-eighth of one per cent). But this did not go far enough in the Bank's view. In particular, the modifications did not affect the existing long-term rate structure which provided little incentive for deposits of one year or over. Despite its dissatisfaction with the inter-bank agreement, however, the Bank refrained from proposing major changes to the prevailing deposit rate structure, preferring instead in September 1960 to direct banks to ensure that the rate they offered on deposits for periods up to three weeks was at least 2 per cent below the Bank rate. This directive, which was evidently more demonstrative than substantive, represented the Bank's earliest initiative in the sphere of deposit rates. Its direct impact was limited, banks attempting naturally enough to get round the directive by offering 3 per cent on twenty-*two* days' deposits. The directive was nevertheless quite successful in its demonstrative role, the agreement banks appearing to have been persuaded by the threat of an imminent Bank intervention to review the interest structure on longer-term deposits and to offer higher rates on deposits of one year and over. Thus from November 1960 the rate offered on deposits of 12–24 months was raised to 3.75 per cent, with the rate rising in stages to 4.5 per cent for deposits of five years or more. The Bank withdrew its directive on rates on 'notice money' in February 1961. Following this, banks raised the rate on notice money to 3 per cent. But the rate on savings accounts also went up to 3 per cent. Deposit rates for maturities of three months or longer too increased, the maximum rate being now set at 5 per cent on deposits of five years or more.

By now, however, the inter-bank agreement had begun to come under strain from within. Early in February 1961, C.H. Bhabha, the Chairman of the Indian Banks' Association, informed the Governor, H.V.R. Iengar, that some medium-sized banks whose deposits had grown poorly in recent months wanted to increase their deposit rates by a quarter of a per cent. The exchange banks, on the other hand, were opposed to this suggestion. Warning the Governor of a possible collapse of the voluntary agreement, Bhabha proposed that the Bank should use its statutory powers to enforce a new integrated interest rate structure. Iengar himself was not averse to the suggestion. But other opinion within the Bank was still far from reconciled to this type of intervention which, in the event, did not prove necessary as banks agreed to a rise in interest rates on savings and term deposits in March 1961.

These rate increases could not paper over the cracks in the agreement for long. Towards the end of December 1961, Tulsidas Kilachand, who had meanwhile taken over from C.H. Bhabha as the Chairman of the Indian Banks' Association, met the Governor to discuss the situation arising out of the notice six banks had given him of their intention to terminate the agreement. These banks, which were all 'medium-sized' and which had deposits of between

Rs 25 crores and Rs 50 crores each, wanted to be allowed to offer a quarter of a per cent more on deposits than 'large' banks having deposits of Rs 50 crores or more. If these six banks did not resile from their position, Iengar and Kilachand agreed, there 'may well be a rate war' that would mark a return to the 'difficult position that was sought to be met by the inter-bank agreement ....' The Governor felt 'if the situation warranted it', the Bank should 'intervene with an appropriate directive to banks on deposit rates'. Asking the Bank's officers to formulate 'concrete proposals', he noted that the urgency of the issue stemmed 'not merely from the impending collapse of the inter-bank agreement but also the coming into force of the deposit insurance scheme'.

As described in another part of this volume, the Deposit Insurance Corporation, and along with it the scheme to insure bank deposits, came into existence at the beginning of 1962. In the months preceding its introduction, officials within the Bank and elsewhere apprehended that depositors of the bigger banks would be encouraged by the insurance scheme to shift their deposits to smaller banks (many of which were not covered by the inter-bank agreement) offering higher interest rates, and secondly that depositors might spread their deposits across several banks to maximize the insurance cover available to them. The Deposit Insurance Corporation was one of many initiatives the Bank took during these years to strengthen India's commercial banking structure. It was also engaged at this time in reducing the number of small, relatively unsound or unviable banks through voluntary or compulsory mergers, and consolidating the banking system. Apart from increasing banking risk, the diversion of deposits from the larger to the smaller banks, the Department of Banking Operations argued, would also retard the Bank's efforts to strengthen the banking system. The department therefore proposed that the Bank should issue a directive regulating banks' deposit rates, and it even circulated a draft directive which specified interest rates for four categories of banks and seven categories of deposits. But the Economic Department vetoed the idea, arguing that the Bank did not have sufficient information about the deposit rates of non-agreement and non-scheduled banks. Until this information was collected, the Bank's economists argued, it was wiser to 'resort to moral suasion ... than to direction'.

> A directive would have to take account of the problems of all parts of the banking system while the information that we have relates to the interest rate structure of members to the Agreement and six non-member banks,

the Economic Adviser, V.G. Pendharkar, noted. Though keener than the Economic Department to take some form of action, Iengar deferred to its

advice which was also echoed by the Deputy Governor, M.V. Rangachari. Although it 'would be a pity if the agreement lapsed', the Bank, the Governor agreed, could not issue a directive to freeze the agreement without knowing why the six banks considered it 'unfair'.

At Iengar's instance, the Executive Director, D.R. Joshi, met representatives of the dissenting banks in January 1962 to seek their views. These bankers argued that the inter-bank agreement weakened their ability to withstand competition from the bigger banks which had abandoned the earlier practice of offering lower rates on deposits as a 'matter of prestige'. The continued refusal of the bigger banks to revise the agreement had left the dissenting banks with little choice but to seek its termination. N.M. Chokshi, the General Manager of the Bank of Baroda, who met Joshi separately on behalf of the bigger banks confirmed that the agreement would be terminated if the dissenting banks opted out of it, after which each bank would be free to quote its own rates for deposits. A fortnight later in February 1962, Kilachand and Chokshi met the Governor to complain about the 'adamant' attitude of the dissenting banks and about the 'scramble for funds and ... chaos in the money market' that would arise if the agreement broke down. The two bankers proposed to Iengar that the Bank should use its statutory powers to 'freeze the existing position'. According to Iengar, who had by now grown more wary of bankers' perceptions of the public interest, he

> declined categorically to do anything of the sort. It would be a misuse of the statutory powers given to the Reserve Bank to use them merely for the purpose of enabling the Indian Banks' Association to deal with a domestic difficulty.

However, the Governor felt that the Bank should not hesitate to 'use its powers' if the situation apprehended by the Association, which at present was 'merely an assumption', developed as the two bankers anticipated. In any case, he pointed out, the Bank may have to intervene to regulate deposit rates 'in the context of the situation that might develop as a result of the setting up of the Deposit Insurance Corporation'.

Eventually, such an initiative did not prove necessary. The introduction of deposit insurance did not unsettle the deposits of the larger banks; while the threat posed to the inter-bank agreement by the dissenting banks was defused following its modification in June 1962 to provide for four categories of banks. The dissenting banks were placed in a newly-created 'medium-sized' category comprising institutions whose aggregate deposits ranged between Rs 25 crores to Rs 50 crores and were allowed to offer depositors one-eighth of a per cent more than the interest rate offered by banks in the largest category.

This formula incidentally, had originally been devised by the Department of Banking Operations and had formed the basis of its abortive proposal for a directive on banks' deposit rates.

It was at the initiative of the Bank that the question of regulating deposit rates returned to the fore in 1964. In March that year, Bhattacharyya wrote to scheduled banks suggesting that they examine afresh the interest rates they offered on deposits. Explaining the background to his suggestion in a meeting with bankers later the same month, the Governor underlined that the higher statutory liquidity requirements that would come into force in September 1964 and the growing demand for non-seasonal bank credit, especially from industry, necessitated a greater effort at deposit mobilization by the banking sector. Cautioning banks that loans from the Reserve Bank were available only to 'tide over temporary difficulties', he advised them against regarding the Bank as a 'source of finance all through the year'. Higher rates, the Governor told the bankers, would also enable them to compete with non-banking companies for deposits. Following Bhattacharyya's initiative, the Indian Banks' Association set up a committee towards the end of April 1964 with C.H. Bhabha as its Chairman, which favoured retaining the prevailing rates on deposits of up to six months and granting a small increase of a quarter of one per cent in the rates offered on deposits of longer duration. However, even this modest suggestion did not find favour with the members of the Association.

Consequently, opinion began crystallizing within the Bank in favour of regulating the term structure of deposit rates. Bhattacharyya himself appears to have favoured some such initiative, but the strongest advocacy of it came from M. Narasimham who was at this time the Director of Banking Research in the Economic Department. In the course of three notes written in July and August 1964, Narasimham built upon Bhattacharyya's observation to bankers in March that the time had come to 'give fuller play' to the rate of interest 'as a device to attract more funds into the system'. The term structure of deposit rates, he argued, should be such as to induce a larger flow of genuine savings or idle balances into banks in the form of time deposits. But the prevailing rate structure was characterized by a very narrow spread in the rates offered by banks on deposits of various maturities. Three-day deposits earned 3 per cent per annum while two-month, three-month, and one-year deposits earned a quarter, a half, and three-quarters of a percentage point more, respectively. 'The narrow ... spread', he argued, tended to 'discourage the genuine saver' and helped encourage the growth in deposits of non-bank financial intermediaries and other companies which were not easily amenable to monetary control. Advocating a 'rationalization' of the rate pattern,

Narasimham pointed out that left to themselves banks had proved unwilling even to reduce the absurdly high rate of 3 per cent they offered on call deposits, let alone raise rates on deposits of longer maturities. The Bank, he pointed out, had an interest in 'ensuring that the rate structure for short-term money is in alignment with the other market rates, including in particular, the discount rate on treasury bills'. Counselling direct intervention by the Bank, Narasimham proposed that banks should be disallowed from paying interest on deposits of up to a fortnight and should not offer more than one per cent on deposits of 15–30 days. He also proposed rates of 2 per cent on 31–60 day deposits and 3 per cent on 61–90 day deposits. Apart from encouraging longer-term deposits, the proposed rationalization would also help build a market for treasury bills which the Bank, as we saw above, was interested at this time in developing, and make them an attractive outlet for 'house-money' (i.e. the balances of quasi-public authorities such as the Life Insurance Corporation, municipalities, port trusts, and corporate entities) which was currently held in the form of three-day or seven-day deposits at 3 per cent.

Narasimham was not averse to the rationalization being brought about through suitable changes in the inter-bank agreement. But banks, he felt, had become complacent about the 'role of other incentives to deposit mobilization' following the 'faster rate of monetary expansion' in recent years. Recent developments, including the outcome of the Bhabha committee, did not 'give ground for hoping ... banks would be amenable to suggestions' for more realistic rates. The Reserve Bank, he felt, should either make a 'further attempt at moral suasion' backed by the threat of intervention if a voluntary agreement was not forthcoming, or go ahead and issue a directive prescribing ceiling interest rates. Since detailed regulation would be 'cumbersome' and 'difficult to supervise', he proposed confining the directive to deposits of up to three months' maturity while leaving the other rates 'uncontrolled'. As for the rate pattern on longer deposits, Narasimham supported the Governor's preference for letting the State Bank of India, which abided by the agreement without being a signatory to it, act as a 'pace-setter'.

Other opinion in the Bank about these proposals remained mixed. The Deputy Economic Adviser, P.J.J. Pinto, did not share Narasimham's views either on the necessity for regulation or its extent. In a lengthy note, Pendharkar too acknowledged that the structure of deposit rates was in need of reform, but he put forward some alternative considerations. Three-day deposits, he suggested, were not worth worrying about since they only amounted to a little over 2 per cent of total deposits. Arguing that 'action if any' in the sphere of interest rate regulation should be 'guided by considerations

of monetary control', Pendharkar pointed out that ceiling rates on three-month deposits might induce institutional investors to switch their funds to non-banking channels. If the objective of the ceiling is to induce these funds to move into treasury bills, he suggested, 'the yield and tender conditions' of the latter should also be so altered that 'funds are in fact ... diverted' towards them.

In the event, the Bank decided in September 1964 to prescribe maximum interest rates on shorter-term and indicate minimum interest rates on longer-term deposits. Apart from rationalizing the deposit rate structure to enable the banking system to mobilize savings better and thereby help fulfil one of the objectives of the Bank's credit policy, the object of the exercise was also to encourage banks to reduce their dependence upon the Bank for accommodation. According to the Bank's directive, deposits of up to fourteen days were to be offered the same rate as current accounts. Deposits of 15–45 days could be offered interest up to 1.25 per cent and those of 46–90 days up to 2.5 per cent. The latter restriction, some officials within the Bank hoped, would also help make the treasury bill 'an attractive outlet for ... "house-money" '. The *minimum* rates for savings deposits, and time deposits of 91 days, six months, and one year were recommended to be fixed at 3.5, 4, 4.5, and 5 per cent respectively. Banks were also advised to maintain an adequate spread on deposits of longer than a year's duration.

From February 1965 the Bank began *prescribing*, rather than as before merely indicating, minimum rates on longer-term deposits. Following the increase in the Bank rate to 6 per cent that month, the Bank raised the minimum rates payable on 91-day, six-month, and one-year deposits by a percentage point each. The inter-bank agreement, which continued to regulate interest rates on deposits of longer than one year, was also revised to take account of the new reality. In October 1966 however, the Bank simplified the regulatory regime by revoking the minimum rates on deposits of 91 days and six months while continuing to stipulate the maximum rate on savings deposits (4 per cent) and the minimum rate on one-year time deposits (6 per cent). A few months later in April 1967 the Bank also advised commercial banks to standardize rules for savings accounts and distinguish them from those applicable to current accounts. Savings accounts, the Bank reminded commercial banks, should be subject to some 'limitation on the number of withdrawals in a year as well as the maximum amount withdrawable on any one occasion without notice ....'

The impact of the September 1964 rate increases on banks' deposits became the subject of a 'lively controversy' which pitted the larger banks against the smaller- and medium-sized ones. Representatives of the latter emphasized

that the new regulations had helped banks mobilize larger deposits and enabled them to compete with non-banking institutions for longer-term deposits. The Chairman of the State Bank of India claimed, on the other hand, that higher interest rates had 'merely increased the cost of funds to the banks' without greatly increasing their deposit resources beyond what they would have gathered in the ordinary course with the earlier rate structure. Some bankers also argued that the increase in banks' deposit rates had contributed to depressing the capital market since investors' expectations about returns on equities and other stocks were now out of line with what industrial and business enterprises found themselves able to offer.

The Bank however remained positive about the working of the new regime of regulated deposit rates. A review carried out two years after the Bank's first directive to banks on deposit rates concluded that the revision of rates had 'materially lengthened the maturity pattern of bank deposits', the proportion to the total of deposits for one to three years going up from about 6 per cent to nearly 23 per cent after the new regulations were introduced, and those for three years and more rising from 6.4 per cent to 11.6 per cent. The rate increases may also have helped arrest the diversion of bank deposits towards non-banking companies, while the decline in the velocity of deposit money as a result of longer maturities was 'itself welcome in an inflationary situation'. Although the average rate of interest banks paid out on their deposits increased from 2.4 per cent in 1963 to 2.6 per cent in 1964 and 2.9 per cent in 1965, the Bank felt they could compensate themselves by running up higher credit–deposit ratios and making a greater proportion of their advances in the form of longer-term loans which yielded more and cost less to extend and monitor.

CONCLUSION

Writing to the Finance Minister, Sachindra Chaudhuri, about a fortnight before the rupee was devalued in June 1966, Bhattacharyya drew his attention, not for the first time, to the expansionary impact of fiscal operations on monetary aggregates which became more pronounced by the mid-sixties. The background to this warning was provided by the large growth in money supply during the preceding peak season despite a relatively modest increase in bank lending to trade and industry. The Reserve Bank, the Governor underlined, could not view this situation with 'equanimity', because the government's deficits would, together with the normal slack season contraction in bank credit, place large additional resources in the hands of the banking system when there was a 'squeeze on supplies'.

There was no alternative to taking some 'restrictive action on the monetary side' during the slack season. This, Bhattacharyya noted, 'will ... however affect only the private sector'. The Bank had been criticized in the past

> on the ground that its monetary action seeks to control expenditures in the private sector at a time when fiscal operations which are the main element in the monetary imbalance remain uncontrolled. It is also stated that such a situation leads to excessive restrictions inhibiting production in the private sector.

Although the Bank had answered such criticism by pointing to the role of 'private expenditures as a positive element in monetary expansion', there was 'nevertheless ... considerable force in the argument' of the Bank's critics. It was also undeniable, he said, that

> if [the] Government (and here I include the State Governments) were in a position to so order their affairs that recourse to deficit financing had been substantially smaller, the severity of action on the monetary side could, to that extent, be moderated.

The Bank could, of course, desist from intervention. But it would then have failed in its 'primary duty as the central banking authority'. If the Reserve Bank wished to be 'true to ... [its] charter', it would

> necessarily [have] to take an overall view of credit operations and if Governmental operations continue to add liquidity in the economy, we have to try to counteract the effect of this by restricting expansion to the private sector to the maximum extent possible ....

Besides outlining the Bank's proposals, the Governor also communicated his hopes of meeting the 'essential needs of additional credit' during the lean season by continuing refinance facilities for food procurement, exports and defence supply bills, and credit extended to tea gardens, the latter at levels reached at the end of June 1966. Bhattacharyya also proposed lowering the cap on shorter-term deposit rates, among other reasons to reduce the 'administered Treasury Bill rates' to 3 per cent and 'rescind our minimum rates directive insofar as it applies to three months' and six months' deposits and savings bank deposits'.

As already mentioned, the most important part of the Bank's slack season credit policy proposals involved immobilizing the additions to banks' deposits in May 1966. These reserves, Bhattacharyya told Chaudhuri, could be released

when the busy season began or 'as and when ... banks desire to subscribe to government loan issues'. This method of credit control was not, in the end, adopted. Nevertheless the Governor's letter aptly underscores the constraints within which monetary policies came increasingly to be framed by the end of our period, and the trade-offs which the Bank had to make in order to accommodate the central government's 'fiscal operations' while 'limiting the secondary impact of the primary expansion' of money supply arising therefrom. With budgetary deficits regarded, despite the efforts made in the meanwhile to prune them, as an 'autonomous variable' over which it had no control, yet having to discharge its statutory mandate for 'securing monetary stability', by the mid-sixties the Reserve Bank of India's credit policies were on the verge of becoming exercises to find the means of pre-empting funds for a resource-hungry public sector and virtually in the 'physical' rationing of bank funds between competing claimants within the private sector. With the Bank also having to ensure that 'productive efforts in the private sector' were not hurt by its policies, general credit control instruments yielded place to selective instruments deployed both to restrict the flow of credit into some sectors judged by the authorities to be 'inessential', and to encourage lending to 'essential' or 'preferred' sectors.

By the time Bhattacharyya left office and was succeeded by L.K. Jha, the government initiated some measures aimed at fiscal consolidation. But the departures of the recent past had left their indelible mark on the Bank. Nor was there any going back in the emerging intellectual and ideological environment. 'Overall credit controls', according to Jha whose views were apparently shared by his new colleagues at the Bank, 'made no sense ... in a planned economy', and credit policy could subserve the goals of 'development and stability' only by establishing and adhering to 'sectoral priorities'. Jha's views were not new, evoking as they did the first plan document's vision of monetary policy in a planned economy. But for precisely this reason they illustrate, in a way that Bhattacharyya's more equivocal letter to Chaudhuri summarized above does not, the enormous distance the Reserve Bank of India's perspective on monetary policy had travelled between 1951 and 1967. What was in the beginning a heterodox view on monetary policy issuing from Yojana Bhavan had, by the end of these years, become a ruling orthodoxy within the portals of the Reserve Bank of India.

Table 1: Changes in Money Supply, Wholesale Prices, and National Income, 1951–67

Year	Money supply with the public (M1)	% change over previous year	Wholesale price index (1952–53 =100)	% change over previous year	National income (1948–49 prices)	% change over previous year
1950–51	2,018		111.8		8,850	
1951–52	1,804	–10.6	117.9	5.6	9,100	2.8
1952–53	1,765	–2.2	100.0	–15.2	9,460	3.9
1953–54	1,793	1.6	101.2	1.2	10,030	6.0
1954–55	1,921	7.1	89.6	–11.5	10,280	2.5
1955–56	2,220	15.6	92.5	3.2	10,480	1.9
1956–57	2,346	5.7	105.3	13.8	11,000	5.0
1957–58	2,417	3.0	108.4	2.9	10,980	–0.2
1958–59	2,530	4.7	112.9	4.2	11,650	6.1
1959–60	2,725	7.7	117.1	3.7	11,860	1.8
1960–61	2,869	5.3	124.9	6.7	12,740	7.3
1961–62	3,046	6.2	125.1	0.1	13,060	2.6
1962–63	3,310	8.7	127.9	2.2	13,310	1.9
1963–64	3,752	13.4	135.3	5.8	13,970	5.0
1964–65	4,080	8.7	152.7	12.9	15,000	7.4
1965–66	4,529	11.0	165.1	8.1	14,660	–2.3
1966–67	4,950	9.3	191.2	15.9	14,950	2.0

NOTE: All amounts in Rs crores.

SOURCE: *Report on Currency and Finance*, various years.

Table 2: Components of Money Supply, 1951–67

Last Friday of March	Money supply with the public (M1)	% change over previous year	Currency with the public		Demand liabilities		% share in incremental money supply	
			Amount	% of money supply	Amount	% of money supply	Currency	Demand liabilities
1950–51	2,018		1,407	69.7	611	30.3		
1951–52	1,804	–10.6	1,217	67.5	587	32.5	88.8	11.2
1952–53	1,765	–2.2	1,199	67.9	566	32.1	46.1	53.9
1953–54	1,793	1.6	1,229	68.5	564	31.5	107.1	–7.1
1954–55	1,921	7.1	1,312	68.3	609	31.7	64.8	35.2
1955–56	2,220	15.6	1,571	70.8	649	29.2	86.6	13.4
1956–57	2,346	5.7	1,623	69.2	723	30.8	41.3	58.7
1957–58	2,417	3.0	1,674	69.3	743	30.7	71.8	28.2
1958–59	2,530	4.7	1,792	70.8	738	29.2	104.4	–4.4
1959–60	2,725	7.7	1,931	70.9	794	29.1	71.3	28.7
1960–61	2,869	5.3	2,098	73.1	771	26.9	116.0	–16.0
1961–62	3,046	6.2	2,201	72.3	845	27.7	58.2	41.8
1962–63	3,310	8.7	2,379	71.9	931	28.1	67.4	32.6
1963–64	3,752	13.4	2,606	69.5	1,146	30.5	51.4	48.6
1964-65	4,080	8.7	2,769	67.9	1,311	32.1	49.7	50.3
1965-66	4,529	11.0	3,034	67.0	1,495	33.0	59.0	41.0
1966-67	4,950	9.3	3,197	64.6	1,753	35.4	38.7	61.3

NOTES: (1) All amounts in Rs crores.
(2) Demand liabilities include 'other deposits' with the Reserve Bank.

SOURCE: *Report on Currency and Finance*, various years.

Table 3: Reserve Bank's Advances to Banks against Government and Other Trustee Securities

Year	Scheduled Banks		State Coop. Banks		All Banks	
	A	O	A	O	A	O
1951–52	171.0	24.8	4.9	2.3	175.9	27.1
1952–53	96.4	15.7	3.9	1.9	100.3	17.6
1953–54	136.7	12.8	7.0	3.0	143.7	15.8
1954–55	198.8	10.6	9.8	3.8	208.6	14.4
1955–56	268.6	33.6	10.4	2.1	279.0	35.7
1956–57	456.5	31.6	8.9	3.8	465.4	35.4
1957–58	317.0	15.3	12.7	2.5	329.7	17.8
1958–59	399.8	50.0	15.9	3.5	415.7	53.5
1959–60	502.1	52.1	16.4	4.0	518.5	56.1
1960–61	817.1	49.2	27.0	3.9	844.1	53.1
1961–62	358.4	12.6	32.3	4.9	390.7	17.5
1962–63	337.9	19.1	50.4	6.7	388.3	25.8
1963–64	469.2	47.6	39.3	7.9	508.5	55.5
1964–65	752.8	99.5	45.3	9.9	798.1	109.4
1965–66	880.1	17.7	76.8	8.8	956.9	26.5
1966–67	641.1	59.4	71.7	7.8	712.8	67.2

NOTES: (1) All amounts in Rs crores.
(2) A=Advances; O=Outstanding at the end of March.

SOURCE: *Reserve Bank of India Bulletin*, various years.

Table 4: Seasonal Variations in Bank Credit, 1951–67

Year 1	Busy season expansion 2	(2) as a proportion of bank credit outstanding 3	Slack season contraction 4	(4) as percentage of (2) 5
1950–51	182	20.1		
1951			85	46.7
1951–52	62	6.3		
1952			110	177.4
1952–53	50	4.3		
1953			66	132.0
1953–54	53	4.7		
1954			39	73.6
1954–55	63	5.5		
1955			32	50.8
1955–56	164	13.9		
1956			4	2.4
1956–57	148	10.7		
1957			42	28.4
1957–58	89	6.0		
1958			118	132.6
1958–59	182	12.4		
1959			79	43.4
1959–60	189	12.0		
1960			20	10.6
1960–61	199	11.4		
1961			77	38.7
1961–62	204	11.0		
1962			42	20.6
1962–63	203	10.0		
1963			121	59.6
1963–64	376	17.9		
1964			139	37.0
1964–65	407	17.3		
1965			93	22.8
1965–66	310	11.7		
1966			86	27.7
1966–67	426	11.8		
1967			101	23.7

NOTES: (1) All amounts in Rs crores.
(2) Col. 3 is with reference to bank credit outstanding on the last Friday of the September preceding the busy season.

SOURCE: *Trend and Progress of Banking in India* and *Report on Currency and Finance*, various years.

Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
HC/MCP/1	Bank Rate, 1951–67
G.60	Amendments to the Reserve Bank of India Act of Sections 33(2), 37, and 42
C.366	Variable Cash Reserves—Correspondence
A/c 57(2)57	Finding Eligible Assets for the Issue Department
EDBD.2. 15A/B1.1005	Notes on Credit Policy
BFF 14	Report of the IMF Mission to India (Bernstein Report)
PF 22	Bill Market Scheme
C.297	Advances to Scheduled Banks under Section 17(4)(c) of the RBI Act
C.96	Creation of a Bill Market in India
B.1.1410	Regulation of Interest Rates on Deposits and Advances
B.2.0062	Savings Bank Rules of Banks in India
MS.47/1949-66	Money Supply

Memorandum of Evidence submitted by the Governor of the Reserve Bank of India to the Radcliffe Committee

Memoranda to the Central Board and Committee of Central Board