

## Managing the Centre's Finances

The Reserve Bank's role in relation to the finances of the Union derives from the statutory provisions of the Reserve Bank of India Act, 1934. Section 20 of the Act requires the Bank to accept and pay out monies on behalf of the central government 'up to the amount standing to the credit of its account and to carry out its exchange, remittance, and other banking operations, including the management of the public debt of the Union'. For its part, the central government is required under section 21 to entrust to the Bank 'on such conditions as may be agreed upon, ... all its money, remittance, exchange and banking transactions in India, and, in particular ... deposit free of interest all its cash balances with the Bank ....' The Bank is also entrusted, again 'on such conditions as may be agreed upon', with the 'management of the public debt [of the Union] and with the issue of any new loans' by the central government. In the event of a failure to 'reach agreement on the conditions' with the Bank, the central government is empowered to 'decide what the conditions shall be'. But it cannot conduct these transactions otherwise than through the Bank except at places where the latter has 'no branches or agencies'. At such centres, the central government is allowed to 'hold ... such balances as it ... require[s]'. But the government is expected in practice to operate at these centres too through the Bank, with the latter appointing an agency bank (the Imperial Bank of India, later the State Bank of India and its subsidiary banks) to carry out some governmental functions on its behalf while itself retaining responsibility for the safety of government funds. In addition to the provisions of the Bank Act, the powers of the Bank to manage the public debt of the Union were reinforced by the Public Debt (Central Government) Act, 1944 which came into force from May 1946.

The statutory provisions of the Reserve Bank of India Act were underlined by the agreement the Bank and the Government of India reached in April 1935 concerning the operational details of their banking relationship. This agreement (which remains valid to this day) was supplemented from time to

time in specific aspects, such as for example the size of the central government's minimum balances and arrangements for extending temporary financial accommodation, through letters exchanged between the Bank and the government. (The Bank's agreements with provincial or state governments are discussed in the next chapter.) The Imperial Bank of India functioned as the Bank's agent for the first two decades of the latter's existence at centres where it was not directly represented. The agency role passed to the State Bank of India when it came into existence in July 1955. From the early 1950s, the Bank also engaged state-associated banks such as the Hyderabad State Bank and the Bank of Mysore to act as its agent in regions where these institutions had a strong presence. It should be added, for the sake of completeness, that the Bank remunerates these banks on the basis of agreed formulas which are revised from time to time. But it is not itself entitled to any remuneration for performing ordinary banking functions for the central and state governments other than the benefit it derives from holding their interest-free minimum balances. As a result, its governmental banking responsibilities might leave the Bank out of pocket. However, the Bank is compensated at agreed rates for managing the debt of the central and state governments, and for issuing their loans.

### PREPARING A LOAN ISSUE

Issues of government loans required careful preparation: not only did the Bank wish to obtain funds on the best possible terms and conditions for its most important clients, it had also to ensure that the adverse effects of public borrowings on trade and industry were minimized to the extent possible. To some extent, of course, these objectives could be met through careful timing of government issues. The prevailing practice was to float government loans during the slack season. This arrangement suited everybody: the borrowing governments and trade and industry since they no longer competed simultaneously with each other for funds, and the banks and institutions which principally subscribed to gilt-edged stock since it helped ease the seasonality of their lending operations. As the Committee on Finance for the Private Sector (or the Shroff Committee) pointed out approvingly in 1954,

loan issues should normally be so arranged that the money markets are not subjected to an additional strain when banks are expected to meet the requirements of trade and industry during the busy season.

Although the peak season generally ended in April, it was not until May or June each year that the return flow of credit to the banking system acquired

significant proportions and banks began to feel awash with funds. Though exceptions were made during some years, it became something of a custom during the 1950s and 1960s to issue government loans between the months of June and September every year.

A major consequence of the extension to state governments of its role as their banker (discussed in the next chapter) was the centralized flotation by the Bank of loans of state governments. The general practice was for the central government to come to the market first. The financial requirements of the Government of India were given precedence because, besides being the single largest borrower, the loans it raised were 'intended for the benefit of the country as a whole in contrast to ... state government loans which are for the benefit of the people of the state concerned'. The terms on which the central government's loans were issued and its success in raising them also helped set a benchmark for state government loans. On the credit of the central government rested 'a good deal of public finance'. Twice during the 1950s and 1960s, loans of the central and state governments were floated together. But for reasons discussed below, this experiment did not succeed and was abandoned.

Although loans were not usually floated until June the following year, preparatory work at the Bank got under way from early December. The principal object of the preliminary exercises was to arrive at a reasonably accurate estimate of the size of the loans the central government (and those in the states) could raise from the market before their respective budgets were finalized. Informal consultations between the Bank and officials of the Finance Ministry culminated usually in the Bank preparing a note outlining its assessment of the conditions in the market, the likely trend in interest rates, and a suitable maturity pattern for the central government's new offerings. But the critical decision was without doubt the amount of money each of the borrowers could raise in the market during the year. Plan estimates provided a target for net public borrowing which governments sought to meet. The former were sometimes 'bumped up', often for non-economic reasons, and without much thought being given to the ability of the market to meet the resulting demand for funds. But the Bank, which had its ear closer to the ground, often judged the market incapable of absorbing the loans hopeful governments wanted to unload upon it and would advise them to lower their sights. This led, naturally enough, to a certain amount of bargaining—particularly, though not solely, with state governments.

The major details of the central government's loans were usually left to be settled, especially in the early years, during discussions between the Governor and the Finance Minister. The practice which finally evolved with respect to state loans was that state governments communicated to the Bank their loan requirements some time during the course of January each year. After these

communications were received, the Bank prepared a note containing its assessment of the amounts individual state governments would be able to obtain from the market. This assessment generally formed the basis of the central government's own views on this subject; and once the latter were made known, the Bank wrote to each state government intending to raise funds about the conditions prevailing in the capital market, the amount which it would be able to raise, the rate of interest it should offer, and the currency of its loan. As we will observe at some length in the next chapter, before this arrangement could be regarded as settled, however, doubts had to be resolved over the relative roles of the Bank and the central government in vetting state governments' loan proposals and the degree of autonomy the Bank exercised whilst judging their feasibility. In the early years particularly, officials of the Bank also held meetings with ministers and officials of state governments to finalize details of their loans but equally to help equip them to manage and promote their issues at the local level. State governments quickly became adept at promoting their loans, sometimes in rather unorthodox ways. Although meetings between the Bank and officials of state governments did not altogether cease and differences between them might persist over a number of issues, the preparatory stages of the loan issue were soon largely executed in the manner of a well-rehearsed drill. So much so, the Bank's letters to state governments enclosed drafts of their respective loan notifications, leaving some details such as the issue price of the loan to be finalized later. Closer to the time of the actual flotation, the Bank conveyed to state governments its views on the rate of interest they should offer on their loans and the price at which the latter should be issued. Although state governments sometimes disputed the Bank's judgement in these matters, as indeed its views on the amounts they could safely hope to raise and on the timing of their loans, they grew by and large to come to terms with the Bank's advice about their loan operations.

State government loans were typically issued together. One problem which cropped up with disturbing regularity in arranging state loans was that of preserving the secrecy of the latter's terms until they were formally announced. Unavoidably over the years, the practice developed of each state floating a loan being apprised of the terms of the other states' loans 'in order to enable [it] ... to decide the various issues' connected with its loan. Once the terms were regarded as settled but well before they were published, state governments began canvassing subscriptions from banks and other institutions. As a result, the details of an impending flotation of state loans became widely known in advance. Preserving secrecy required the cooperation of the state governments, and this proved elusive in practice because no state wanted to be left behind in the race to raise subscriptions from commercial banks and

other institutions. As B.C. Roy, the chief minister of West Bengal, told the Deputy Governor, K.G. Ambegaokar, in 1959, some years earlier his officials had deferred approaching banks until the loan was announced, only to find that the latter had 'already made commitments to other state governments who had got at them earlier'. But the Bank, unlike the central government, was not on the whole disposed to worry about this lack of secrecy. There was so little speculation in state loans, Ambegaokar argued, that nobody could use the advance information, which was in any case available quite widely in the market, to 'make any big profits'.

Once loans were thrown open to public subscription, the Bank maintained a close and regular watch over their progress, keeping in frequent touch for this purpose with state governments and its own offices over trunk telephone (in the 1950s and 1960s this meant booking calls several days in advance of the actual event for a predetermined time of a particular day), or through telegrams transmitted in code.

#### CENTRAL GOVERNMENT LOAN OPERATIONS

The central government's loan operations in the late 1940s were, according to the Deputy Governor, N. Sundaresan, marked by 'continued barrenness'.



N. Sundaresan, Deputy Governor, 1950-54

Despite Sundaresan's reputation for bluntness, this was an understatement. Net borrowings had actually been negative for four consecutive years from 1947–48 to 1950–51. Although the reasons for this were varied, a major factor was the political and economic uncertainty which followed the partition of the subcontinent. Even as late as May 1950, the Finance Minister, John Matthai, felt uncertain political conditions ruled out a long-term loan and preferred to make a 'decent success' of a medium-term loan to courting infamy with a long-term one. The Bank and the government decided initially to follow Matthai's instincts and float a medium-dated loan before better counsel prevailed. Sundaresan in particular argued that, though more likely to succeed, a medium-term loan would alert the market to the government's lack of faith in its own credit. If state governments followed the centre to float medium-term loans, 'we would have converted the gilt-edged market to a new philosophy, namely that the governments themselves are not sanguine of [their] long-term credit'. Cautioning against sacrificing 'for a mess of pottage of an eight-year loan ... the prospect of successfully floating a long-term loan ... for quite a number of years', he recommended holding the medium-term loan in reserve while the government tried out a modest long-term loan mainly targeted at institutions having the 'stomach' for such investments, since it was easier in a 'jittery market' to move from a long-term loan to a medium-dated loan than vice versa. On the other hand, if the object of a medium-dated loan was to signal a break with the prevailing policy of 'simulated cheap money', it was better

to take the bull by the horns and float a straight 3 per cent loan at par and face any criticism that may be levelled against such a move. The plunge has in any case to be taken if we want a swim and the shiver will only last but a while.

In the event, the Bank and the government followed Sundaresan's own preference and floated a fourteen-year, 3 per cent loan issued at par for Rs 30 crores in June 1950. Despite being the first long-term loan to be offered for cash in nearly three years, this loan was fully subscribed.<sup>1</sup>

<sup>1</sup> Subscriptions for new government loans were accepted either in cash or in the form of specified maturing government securities. 'Conversions' referred to the issue of new loans against the tender of maturing loans. Although it was not unknown for new loans to be available only against either cash or maturing loans, most loans invited subscriptions in both forms. The last long-term loan for which cash subscriptions were accepted prior to the fourteen-year 1964 loan offered in June 1950 was the fifteen-year loan offered in November 1947.

The inauguration of planning in 1951 coincided with a gradual abatement of political and economic uncertainty. But this did little immediately to lift the clouds hanging over the market for central government loans.

Market sentiments remained adverse towards government loans during the first two years of the first plan. Hence, while the 1951–52 budget took credit for public borrowings of Rs 100 crores, an issue for only half this amount was floated in August 1951 in the form of a seven-year loan at 3 per cent. Although the loan was fully subscribed, cash subscriptions amounted only to about Rs 12.8 crores. Cash repayments during 1951–52 of maturing loans amounted to over Rs 47 crores, so that the government's net borrowing during the year was once again negative. The issue of a seven-year loan at 3 per cent was widely perceived to signal the beginning of a policy of dearer money and indeed, the Bank rate was put up by half a percentage point in November 1951.

The central government did not float any loans in 1952–53. Partly for this reason and thanks to the paucity of floating stocks and rumours of a reduction in the Bank rate, the gilt-edged market remained firm during these months. In June 1953, the Government of India returned to the market to raise Rs 75 crores in the form of medium-term National Plan Bonds (First Issue). The issue was fully subscribed, but cash subscriptions amounted to only Rs 23 crores. With cash repayments during the year totalling over Rs 63 crores, there was once again a net outflow from the central government's loan account of about Rs 39 crores. But since the latter amount almost exactly equalled the government's own holdings in its cash balance investment account of the 3 per cent 1953–55 loan which fell due that year, the repayments did not involve an actual net outflow of funds from the exchequer during the year.

#### *The National Plan Loan*

In the absence of large investment outlays, the budgetary position of the central government had remained easy during the early 1950s. But with the first plan outlay having been stepped up from 1953–54, a major new experiment was attempted in 1954 to translate the perceived public enthusiasm for the government's new developmental initiative into support for its loan programme. This experiment had some distinct features. All central and state loans for the year were centralized into a single National Plan Loan which opened for public subscription in April 1954. Unlike other government loans which closed within a few days, this loan was kept on tap until the middle of September. In a further effort to motivate the individual investor, the opening of the loan was accompanied by sustained efforts at the political and governmental levels to whip up public enthusiasm for it.

Although a loan such as this one had been talked about for some time, the immediate inspiration for this experiment was provided by Jawaharlal Nehru's address to the annual session of the Indian National Congress at Kalyani in January 1954. In the course of his speech, Nehru deprecated the tendency to depend solely on institutions for subscriptions to government loans and called for a popular campaign to mobilize financial resources for development. Nehru's call was echoed in a resolution passed at the session to harness popular support for a development loan, particularly among small investors. Soon after the Kalyani session, the Finance Minister, C.D. Deshmukh, initiated consultations with the Bank about a loan which he proposed should be kept on tap for about six months and a portion of whose proceeds would be distributed among the states agreeing to stay out of the market during the year.

Officials at the Bank harboured some misgivings about the proposal. In particular they wanted to make sure that the additional resources raised on behalf of state governments were used to reduce the quantum of deficit financing rather than to increase the size of existing plans which already stretched available 'physical and human resources' to their limit. Officials were also nervous that the success of the loan among individual investors, particularly in the rural areas, would come at the expense of collections under the small savings scheme which were already showing a 'declining trend'. There was some apprehension besides that larger government loans would lead in the first instance to a reduction in the resources available for investment by the private sector. But the Bank's overall response was positive. Unlike his deputy, Sundaresan, who felt it would mean 'nursing ... state governments with varying market credit', the Governor, B. Rama Rau, was not unfavourably disposed towards the principle of a common centrally floated loan. In fact, earlier in 1952 Rama Rau and Deshmukh had discussed between themselves the possibility of a 'big Central Development Loan of at least Rs 100 crores in the flotation of which the Prime Minister ... would take an active interest'. Nothing came of this idea at that time, but Nehru's address and Deshmukh's response to it provided another opportunity to carry out a similar experiment in 1954.

Hence the essential principle of floating a central loan—which in due course was christened the National Plan Loan—was settled without any great delay. It was also clear from the beginning that the loan would be available on tap. The Bank preferred the loan to open early in May after the busy season ended and funds began returning to banks. A mid-April opening, as the government proposed, might be better from the point of view of attracting subscriptions from the public, particularly from rural households still in



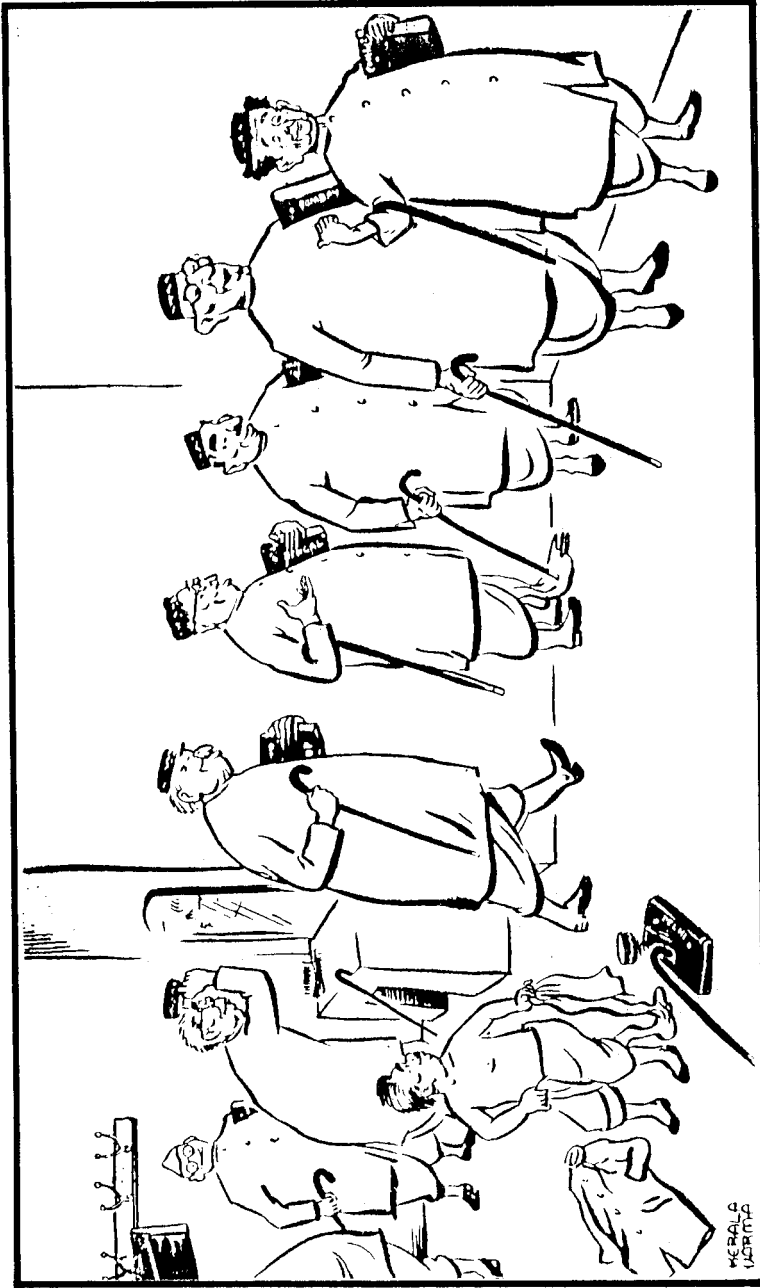
possession of the proceeds of the recent harvest, but the Bank felt this consideration was outweighed by the 'great psychological effect and ... stimulus' that would be given to the loan by a 'substantial contribution from institutions in the early stages'. On the other hand, even if the loan was kept open for six months, it would be hard to overcome the 'depressing effect' of a poor start. The middle of April, moreover, was 'a really bad time of the year for any future Finance Minister to tackle [the] repayment', when it fell due, of the large amounts proposed to be borrowed through the National Plan Loan.

There was general agreement that while no size would be fixed for the issue nor any target figure disclosed in public, the government should aim to raise Rs 150 crores to Rs 200 crores through the loan. A ten-year maturity was decided upon, ironically enough for fear that anything longer could prove unpopular with banks and institutions. It was also decided that the loan would carry an interest rate of 3.5 per cent and be sold initially at Rs 98-8 so as to give a yield to redemption of 3.68 per cent, and that its price would rise by 9 pies per cent, which was the approximate net interest accruing each week. Apportioning the proceeds of the loan between the states threatened to be a rather more difficult matter, but this too was quickly resolved, largely thanks to the central government holding firmly to the view that the Bank's judgement of the amounts each state would have been able to raise in the market on its own strength should form the basis of the eventual allocation. If any state was not prepared to accept the allocation, it could, in Deshmukh's words, 'try its luck in the market afterwards although ... with the Central loan on tap, no state would take this risk'.

The National Plan Loan, 1964 was announced on 12 April 1954 and opened for public subscription a week later. The loan announcement was accompanied by an appeal from the Prime Minister to the nation and to chief ministers of states. The object of the loan, Nehru affirmed, was to involve everyone 'as partners' in the 'mighty adventure' of building a 'new India'. The success of the loan, he declared, would provide 'a measure of our self-reliance and of our determination to meet all contingencies'. The Governor too issued a special appeal to the Directors of the Bank's Central Board requesting them to persuade their friends and the institutions over which they had some influence to subscribe generously to the new loan.

The loan which was kept on tap for nearly five months was closed on 15 September 1954. The total subscriptions received for the National Plan Loan amounted to Rs 158 crores. This was far larger, on the face of it, than the amounts the central and state governments had been able to borrow in previous years. Nearly a quarter of the subscriptions came from areas outside the big

*Brokers All !*

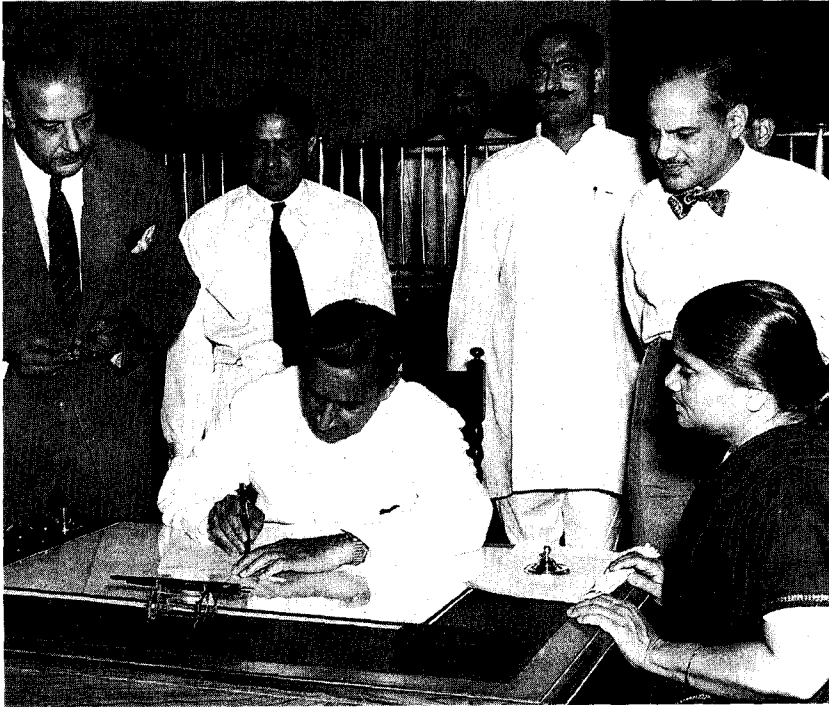


The State Governments are actively cooperating with the Centre in selling National Plan Bonds.

- Shankar's Weekly, 11 July 1954

centres of Bombay, Calcutta, and Madras, and were received at mofussil offices of the Imperial Bank, treasuries, or subtreasuries.

In truth, however, the success of the National Plan Loan was more apparent than real. Its principal object—of converting popular enthusiasm for planned development into resources for investment—was only partially realized, with relatively small subscriptions (defined rather generously as those up to Rs 5,000) contributing only Rs 6 crores, or less than 4 per cent of the total loan. On the other hand, the Bank's own contribution to the National Plan Loan amounted to Rs 58 crores or nearly 37 per cent of the total. Thanks to the political and other capital invested in this loan, the Bank felt itself under greater pressure than usual to make up for the shortfall in public subscriptions to it. Besides, while no target figure was publicly prescribed for the loan, the practice of publishing subscription figures at regular intervals largely in order to sustain the campaign's momentum obliged the Bank to make what was in effect an open-ended commitment towards ensuring the loan's apparent success.



Finance Minister C. D. Deshmukh inaugurating the National Plan Loan, 1964.  
Durgabai Deshmukh is on his left.

In addition to the Bank, the central government subscribed Rs 10 crores to the loan, and the state governments Rs 7 crores. Thus collections from the public amounted only to about Rs 83 crores. This was not far in excess of the Rs 80 crores the central and state governments had managed to raise separately and rather more unobtrusively from the public the previous year. The biggest contributions to the loan came from states in which the traditional money market and commercial centres were located, viz. Bombay, Madras and Andhra, West Bengal, and Punjab. While a majority of the state governments staked little on the success of the loan and made no effort to motivate prospective subscribers in their areas, other states such as Punjab and Madras 'resorted to pressure of an undesirable sort'. By May 1954 reports were being received of industrial magnates and other affluent investors succumbing to pressure from some state governments and subscribing to the National Plan Loan by selling their existing holdings of government securities. So widespread was this practice that it led to a fall in the price of government securities all round. 'It looks as though the new loan has cast a depressing effect on the gilt-edged market', Sundaresan observed in May 1954.

Worse abuses were also reported. In Punjab, where districts were encouraged to compete with one another to raise subscriptions for the loan, *tehsildars* collected funds from contributors who received nothing in return except the goodwill of local government officials. These contributions were made over to the Punjab National Bank (with which the Punjab government entered into an informal arrangement) as its commission for subscribing to the loan in its own name. The commission (or the discount on the loan which was made good by public contributions) was calculated initially at the rate of 1.5 per cent of the loan taken up by the institution. Not satisfied with this, the bank attempted to raise the commission rate to 2 per cent, but its efforts were thwarted by state government officials' successfully persuading the Allahabad Bank to subscribe to the loan at a commission of one per cent.

In Madras and Andhra, several banks were persuaded to advance up to 95 per cent of the principal amount of the loan. Officials of the state government then got into the act, collecting Rs 5 each from members of the public who were made to apply for a bank loan at the same time as they applied to subscribe to the government loan. These involuntary buyers were also required to execute sale advices for their securities. Banks in the state then sold the scrip at a discount of 4 to 6 annas and the proceeds of such sales were adjusted against the advance and the accrued interest, with the balance being shared apparently between agents and officials. The 'rural' investor, the Bank ruefully noted, was 'content to make a small sacrifice in order to keep himself

in the good books of ... revenue officials to whom he has to look ... for various concessions and facilities'.

Similar practices were to become a common feature of state loans in later years, but in 1954 the Bank apprehended that the new loan would go to a discount because of the manner in which it had been raised. It did not take long for these fears to be realized. Selling pressure became evident in Punjab and Madras almost immediately after the loan closed, with the Punjab National Bank emerging as a persistent seller of the loan and two Madras brokers transacting sales of the loan to the tune of nearly Rs 3 crores. As a result, while earlier central and state government loans remained steady after the early flutter, or showed some improvement, the National Plan Loan proved decidedly weak, market quotations for it receding from Rs 98-5 immediately after the close of the loan to Rs 97-11 by November 1954 before rising to Rs 98-8 largely on the back of purchases by the Bank. Needless to add, thanks to the continued selling pressure the Bank was unable to make any sales out of its substantial holdings of the National Plan Loan.<sup>2</sup> Nor indeed, for that matter, could the Punjab National Bank which still held Rs 9.25 crores of the loan. The latter amounted to over 11 per cent of the money originally subscribed by the public to the loan and about 30 per cent of the total holdings of this loan in banks' portfolios in June 1955. The National Plan Loan remained a persistently weak performer down the years. The market was fully saturated with the loan and its price 'always tend[ed] to sag'. 'We must reconcile ourselves to the position that we may have to hold this baby indefinitely', Ambegaokar remarked some two years after the loan.

The fact of the matter is that this loan was unduly forced [upon unwilling investors] ... by state governments and is in fact a warning against any combined loan ... or any attempt to issue one loan of a very large size.

The Reserve Bank had come to the same conclusion much earlier. The combined loan, in its opinion, did not achieve any 'notable success' and separate loans were better from every point of view. While a majority of the state governments responded passively to the National Plan Loan campaign, the Bank felt they would be more willing to mobilize contributions for a loan whose proceeds they could retain in full without having to look to the centre for their assured share of the receipts of a combined loan. Besides, when

<sup>2</sup> Indeed, as table 5 (at the end of the chapter) shows, 1954-55 was the only year of the first plan during which the public's net absorption of government securities was lower than the net market borrowings of the central and state governments.

states came into the market on their own investors would be able to spread their purchases over a number of state loans rather than pour all their money into a single combined loan.

In 1955 the central government reverted to the practice of floating its loan separately, and it came to the market in July with a ten-year loan for Rs 100 crores. There were some differences within the Bank on the coupon rate on the loan, originating mainly from the decision to use these securities to pay compensation to shareholders of the Imperial Bank of India which passed into public ownership in July 1955. Ambegaokar favoured a 4 per cent rate on a longer-term (21-year) loan. Anything less, he argued, would be unfair to shareholders of the Imperial Bank since their shares returned a yield of 4.5 per cent. Besides, it was argued, since a large proportion of those who received these securities as compensation were likely to sell them, a long-term loan which offered a higher current yield without upsetting the overall pattern of gilt-edged rates would also enable the Bank to test the market's appetite for such assets. But another Deputy Governor, Ram Nath, felt a 4 per cent issue would have 'adverse psychological repercussions on the market' and advised a coupon rate of 3.5 per cent. There was also some fear that a 4 per cent coupon rate on a central government loan, no matter how long, might necessitate raising the rate on state loans. Rama Rau and Deshmukh sided with Ram Nath, and the government decided in the end to float the 3.5 per cent National Plan Bonds (second series) 1965 for Rs 100 crores on 1 July 1955 at an issue price of Rs 98.8 for a redemption yield of 3.68 per cent.

The loan was closed three days later. Total subscriptions amounted to Rs 104 crores, but of this only about Rs 30 crores came in the form of new cash. The Bank contributed Rs 15 crores additionally as cash and over Rs 36 crores in the form of conversions, so that it alone accounted for nearly half the sum raised by the loan. However with the 1955-56 budget having made a borrowing provision of Rs 125 crores, Delhi mooted the possibility later in the slack season of raising another loan of Rs 25 crores in the market. The government's proposal was partly inspired by the 'phenomenal success' of the two state loans floated in 1955 and by similar suggestions made in some financial journals. But the Bank was notably unenthusiastic about a second tranche of central government loans which it felt the market was in no position to absorb. The idea of issuing a central government loan fully to the Bank too was scotched, though not on grounds of monetary restraint. Rather the contrary, with Ambegaokar arguing that although such a course would mean more profits for the Reserve Bank, there was 'no special advantage' to the government 'in going in at present for a funded loan for a small amount ...'



K. G. Ambegaokar, Deputy Governor, 1955-60

when it could continue to make 'free and frequent' use of ad hocs to keep itself more cheaply in funds.

#### *The Second Plan Years*

Loans floated and retained by the central government amounted to about Rs 360 crores during the first plan. The second plan document envisaged doubling this figure to Rs 700 crores. The central government's large loan requirements naturally turned the attention of several officials in the central and state governments and at the Bank towards ways in which these could be met. The Bombay government, for example, proposed to the central government a scheme for a so-called 'compulsory savings loan' to help meet the public borrowing needs of the second plan. Some officials from Mysore also backed such a course while both the Madras and the Andhra governments had already made a fine art of wresting subscriptions to their loans from the public. The

Bank rejected the principle of what it called a 'forced loan', since it had the 'disadvantages of both taxation and borrowing and the advantages of neither'. Being involuntary like taxation, it would be equally unpopular. But unlike taxation, forcible loans would leave a 'large future liability' to be serviced, more so as periods and rates which could be regarded as reasonable for voluntary loans would be regarded as unduly long or low for compulsory loans. 'Compulsory borrowing', the Bank argued, would only hinder the scope 'both for taxation and voluntary borrowing' without helping to raise any additional resources for the government. The Reserve Bank also warned the government that any

significant restriction of the scope for taxation in the context of the objective of a socialistic pattern of society on the one hand and any substantial dislocation of the machinery of normal borrowing and lending on the other, through a comprehensive countrywide scheme of compulsory borrowing will be disruptive of the country's system of public finance, of fiscal equity, of the functioning of the capital markets, and seriously compromise the objectives alike of a satisfactory financing of the Plan and of lessening economic inequalities through taxation.

Though the Bombay government's proposal did not survive preliminary scrutiny, it helps illustrate an important aspect of public policy-making in India during these years. Although the second plan provided for a large public borrowing programme, few outside the Bank nor many within it had much idea of the challenges it involved or how these could be met within the existing system of governance.

The Bank too was more hopeful than knowing. For example, while the large, deficit-financed public expenditures likely to arise during the plan could be expected to add to banks' deposit resources, the extent to which these found an outlet in government securities was anybody's guess. The Bank nevertheless began taking steps to tailor the government's loans more closely to suit investor preferences. A major step it took in this direction was to offer in the market a menu of loans of different maturities rather than the single medium-dated loan the Bank had grown used to selling during the first plan.

The idea of a loan-mix originated with Ambegaokar who argued that under the prevailing practice, institutions did not invest in central government loans to the extent they might for fear of ending up with unbalanced portfolios. Some banks such as the State Bank of India and the Punjab National Bank already had large holdings of a single loan (the 1965 and 1964 loans, respectively). On the other hand, there were few short-dated loans (i.e. loans



maturing in 1961 and 1962) which were 'easily available' in the market. Besides, the Bank too had large holdings of the 1964 and 1965 loans, but its holdings of loans of other maturities were already so low that it could not afford to allow them to drop any further. If the government put several different loans on the market as part of a single issue, Ambegaokar maintained, it would 'in the aggregate give a much larger amount than one loan' whilst saving banks from the 'embarrassment [of] ... having an unbalanced investment portfolio' and enabling the Bank to

rectify the present deficiencies in its portfolio and make available to the market ... more of different kinds of maturities for which ... investors [may] have ... special predilections.

Ambegaokar's proposals met with general approval, and instead of a single medium-dated loan, the government decided in June 1956 to issue three loans of varying maturities. The three loans comprised a relatively short-dated 3.25 per cent loan maturing in six years, an eleven-year medium-dated loan at 3.5 per cent, and a long-dated eighteen-year loan at 3.75 per cent. No individual limits were prescribed, but a total amount of Rs 150 crores was fixed for all three loans. The Bank and the government also decided to adopt the existing practice in respect of state loans and retain excess subscriptions of up to 10 per cent (as against the prevailing 5 per cent) of the total issue. The loan, which opened on 16 July, closed two days later after aggregate subscriptions amounting to Rs 158 crores, including Rs 77 crores in cash, were received. The Bank was once again the major contributor, accounting for over half the total loan proceeds or about Rs 81 crores, of which just over half was in cash and the remainder in the form of conversions. The long-term loan, whose performance was watched with interest since it had the longest maturity of any loan issued since 1946, failed to live up to expectations, with subscriptions to it from lenders other than the Reserve Bank amounting only to about Rs 21 crores. The medium-dated loan did worse, the corresponding figure for it being about Rs 19 crores. The short-dated loan evoked the best response, with lenders other than the Bank contributing Rs 37 crores towards it. But even this scrip did poor cash business—cash subscriptions to it amounting only to Rs 10 crores. Commercial banks in particular, appear to have taken a guarded view of the future, using the opportunity offered by conversions to stretch their 1957 maturities merely as far as 1962. Thus nearly Rs 20 crores of the Rs 24 crores worth of securities they offered for conversion were invested in the short-dated loan. In contrast, the entire conversion offering of the Reserve Bank, of Rs 38.38 crores, was invested in the long-dated loan—strong evidence indeed that in the summer of 1956 there was a deep schism

separating the Bank's perception of the gilt-edged market from that of the commercial banks.

The Bank could not afford to be oblivious to these disquieting trends in investor perceptions. These trends were heightened, moreover, by the debacle of state loans floated in 1956. As we observe in greater detail below, a significant proportion of these were bought by investors under pressure from state governments and were financed by banks. Expectedly, strong selling pressure developed soon after these loans closed, and many state government loans went into discount. Central government securities too were caught in the melee. The volume of government securities in the market was clearly greater than it could absorb: not only was net absorption by the public of central and state government securities only half their net market borrowing, the Bank too turned a net buyer in the market during 1956–57 (tables 5 and 7 below). In addition to these factors, the monetary stringency which characterized the 1956–57 peak season and the rising demand for credit for investment also appeared to the Bank to rule out a large central loan.

There was thus, in the Bank's view as it formed in January 1957, 'very limited scope for fresh borrowing' during the year. Though the government might wish to put its borrowing figure at Rs 100 crores in order to 'make a good showing', Rs 50 crores represented the more realistic target. But even this amount could not be included in the budget estimates without disturbing the market. Hence Ambegaokar wondered whether the government should not 'camouflage the figure by giving a combined estimate for borrowings from the market ... [and] the small savings scheme' so that the market was kept guessing about its plans. In view of the 1956 experience, Ambegaokar also argued that it would be of 'tactical advantage to have a fallow year' for state loans to 'enable the market to get over the indigestion of the last issues'.

In the end the government decided to float a loan of Rs 100 crores in the form of a 3.75 per cent bond maturing in ten years and a 4 per cent loan maturing in 1972. These rates were pencilled in April 1957 and endured the increase in the Bank rate from 3.5 per cent to 4 per cent towards the middle of May. The loan was originally scheduled to be announced on 29 July, but the announcement was advanced by four days thanks to the misadventure of a junior official of the Government of India who managed on the morning of 25 July to lose the draft notification of the loan he was sent to fetch from the government press. The loan which opened on 5 August was closed within three days after subscriptions totalling about Rs 106 crores were received. Once again the apparent success of the issue concealed the fact that cash subscriptions by banks amounted only to about Rs 9 crores (as against Rs 13 crores to the central loan and Rs 20 crores to state loans in

1956), and that the State Bank had to be persuaded to put in a special subscription of Rs 10 crores over and above the Rs 11 crores it had contributed earlier. Results of the conversion too were poor, with only Rs 17 crores of the eligible securities outstanding with the public of Rs 57 crores being tendered for the new loans. Expressing his disappointment, the Governor, H.V.R. Iengar, told Finance Minister T.T. Krishnamachari that the poor response owed largely to the desire of banks to keep their resources liquid because of the monetary stringency and uncertainty about the extent to which they could rely upon the Reserve Bank for assistance in the peak season. The experience of public borrowing in the first two years of the plan also suggested, according to Iengar, that the second plan figures in this regard were likely to prove 'quite unrealistic'.

Despite this gloomy prognosis, the cloud hanging over the government securities market lifted gradually over the next few weeks. Thanks partly to the state governments (excepting Bombay and Mysore) staying out of the market, the large sales of securities banks made to the Reserve Bank, the small purchases they made of the loan floated in August 1957, the substantial increase in the deposit resources of the banking system, and the slower than expected onset of the peak season, the problem of 'indigestion' that Ambegaokar had spoken of was quickly overcome. Instead banks began to feel a pressing shortage of short-dated paper towards the end of the 1957-58 slack season. With the Bank unable to meet this demand because its own cupboard of short-dated securities was virtually bare, in November 1957 the government made a further issue—the first having been made the previous year—of the 3.25 per cent 1962 bonds. This issue of Rs 30 crores was entirely taken up by the Bank for sale on tap to banks and other institutional investors who took little time to absorb it. The market's appetite for gilt-edged stock was only whetted by the new issues. The public's net absorption of government paper in 1957-58 exceeded governments' net borrowing by over 60 per cent and after a gap of a year the Bank once again turned a net seller of central government securities.

Thanks to continued deposit growth and lower demand for bank credit in the peak season, the government's borrowing prospects brightened considerably in 1958. Though the Bank initially suggested a borrowing estimate to the government of Rs 125 crores, it was willing to contemplate a higher figure with equanimity and even adopt the government's suggestion to float the loan in May, rather than in June or July as normally. Thus in May 1958 the central government floated three loans for Rs 135 crores and collected subscriptions of Rs 142 crores including conversions of about Rs 9.5 crores. The short-dated loan, in particular, proved popular with banks who contributed Rs 22

crores to the issue. The Bank's subscription amounted to Rs 60 crores of which Rs 54 crores were in cash. Although this represented the largest cash contribution by the Bank to a central loan after the Rs 58 crores it subscribed to the National Plan Loan, officials at Mint Road were not disposed to complain in the background of the large net sales (of Rs 84 crores) by the Bank of government securities between July 1957 and April 1958. The more noteworthy feature of the year's loan operations from their point of view and from that of the development of the gilt-edged market was the cash contribution made by the other lenders which amounted to over Rs 78 crores.

Despite this issue and loans floated by state governments aggregating to Rs 50 crores, there was persistent excess demand in the market for gilt-edged stock in the autumn of 1958. Some brokers too represented to the Bank about the need to reissue medium-dated loans. Officials in the Bank who considered the suggestion early in August 1958 initially dismissed it. With large maturities falling due between 1963 and 1966, the Bank did not see much merit in making a further issue of any short-dated loans. Nor did there appear to be much demand from banks for medium-dated loans, of which the Bank still held a sizeable stock. But barely a fortnight later the situation had changed. Banks' demand for medium-dated loans led to a sustained rise in their prices, and the Reserve Bank apprehended that unless its stocks were replenished it would be unable to meet the market's demand for them. Therefore, at the Bank's instance towards the end of August 1958, the government issued two loans to the Bank for placing in the market, viz. a further issue aggregating to Rs 30 crores of the 3.5 per cent 1967 loan (whose price rose smartly even amidst speculation about a fresh issue of the stock to necessitate revisions in the loan notification almost up to the last minute) and an equal amount of the all new 3.5 per cent National Plan Bond, 1968. The issue of a new loan to the Bank was a departure from past practice, but officials felt it could be justified in the circumstances if the Bank was not seen to be profiting from its sales of the paper. With these two loans, the central government's borrowings during 1958-59 totalled Rs 202 crores as against Rs 136 crores the previous year. Despite the large size of the government's borrowings and thanks to the easy monetary conditions, the gilt-edged market remained firm throughout the year.

Encouraged by the 1958 experience and having to contend with large maturities totalling about Rs 120 crores, the government proposed raising Rs 225 crores in the form of loans and Rs 50 crores through treasury bills in 1959. The Bank felt the government's optimism to be unfounded. The investment-deposit ratios of banks were already close to 40 per cent and they were unlikely to contribute any large sums to government loans in 1959. The Bank first

pencilled in a figure of Rs 200 crores for central government loans, but decided in the end to issue a loan for Rs 175 crores in the first instance, leaving the remainder to be mopped up as in the previous year through a supplementary issue of loans of suitable maturity. Thanks to a bunching of maturities in the short-dated range, the Bank proposed to issue only two loans, a 3.5 per cent 1969 bond and a 4 per cent 1979 loan. The twenty-year loan was a major new feature of the year's loan programme. The longest loan to be issued since the second world war, it signified the desire of the Bank and the government to lengthen the maturity pattern of the latter's loan obligations and their willingness to suffer higher costs of borrowing for the purpose. The issue of these two loans, which was originally scheduled for the middle of June, was put off to early July because of the delayed end to the busy season.

The July flotation was a success. Total subscriptions amounted to about Rs 184 crores, of which Rs 89.38 crores represented conversions. The medium-dated loan proved the more popular of the two, attracting nearly Rs 103 crores, including the Bank's entire cash subscription totalling Rs 35 crores. The Bank did not judge the latter, and its contribution by way of conversion of about Rs 45 crores, to be excessive in relation to the volume of securities it had sold in the market during the previous twelve months, and was quite sanguine about the possibilities of offloading its new acquisitions during the course of the year.

The state loans floated in August 1959 turned out to be 'phenomenally oversubscribed', an aggregate issue of Rs 61.5 crores attracting subscriptions of over Rs 100 crores. As the Finance Minister, Morarji Desai, confessed to Iengar, he would have liked to transfer the excess subscriptions to state loans 'if it had at all been possible to ... a corresponding central loan' to obviate the issue of a second tranche of the latter. Since that was not possible, the Bank and the government turned their thoughts towards floating a second loan, prospects for which were now suddenly brighter. The original intention, unlike in the past, was to make a public issue of the second loan, but when the time came to do so in October, the Bank decided it should take up the proposed issue aggregating to Rs 45 crores. Apart from the merits of approaching the markets again for a relatively modest amount, the Reserve Bank appears to have felt early in October 1959 that its stock of competitive short-dated paper could do with some replenishment. The Bank had lately been encouraging commercial banks to invest in short-dated stocks. But since the latter were in relative short supply, there was a perceptible hardening in their prices which, among other things, caused complications in the pattern of yields in the market. While its open-market operations would have benefited immediately from an additional issue of competitive 1964 paper, the Bank had to balance

against this the danger of loading the year too heavily. The year 1964 was already one of heavy maturities—the National Plan Loan, for example, falling due that April—and releasing more 1964 paper in the market might mean smaller conversion possibilities and larger loan repayments. Hence the Bank reverted to the advice it had favoured earlier of stretching out future maturities to the late sixties and beyond, particularly since the shortage of short-dated securities had also led to a ‘hunger [among] ... the banks’ for medium-dated stocks. However the idea of making the issue to the Bank rather than to the market endured the change in its composition. As later events were to show, the Bank’s judgement was probably mistaken in both respects, but the die had been cast and in October, the government issued two loans—a 3.5 per cent 1969 and a 3.75 per cent 1974 for Rs 25 crores and Rs 20 crores, respectively—to the Bank. Although, thanks to the second issue, the central government’s gross borrowings were higher in 1959 than in 1958, its net borrowings were substantially lower at Rs 107 crores as against Rs 181 crores the previous year. But this was to some extent offset by the sale of treasury bills.

Initial plans for the 1960 loan season were largely framed against the happy background of the government’s success in mobilizing funds in 1958 and 1959. Although the Bank felt even in January that the government’s estimate of Rs 225 crores for market loans was ‘somewhat on the high side’, it was not on the whole inclined to demur. The government, on the other hand, adopted Rs 250 crores as its market borrowing target in the budget. But monetary conditions turned stringent later in the year—while the demand for credit remained persistently strong, the Bank imposed stiff reserve requirements on banks’ additional deposits in March 1960—and the government followed the Bank’s advice to lower its initial borrowing target to Rs 175 crores. Two loans—including one for twenty years—were floated towards the middle of July 1960 to raise this amount. Total subscriptions to the loans amounted to about Rs 180 crores, of which Rs 106 crores were in the form of cash. The Bank put in Rs 50 crores in cash and effected conversions of nearly Rs 38 crores. As expected, the contribution of commercial banks other than the State Bank fell sharply from more than Rs 26 crores the previous year to about Rs 8.5 crores in 1960.

Though its cash subscription was considerably larger than in the previous year, the Bank looked upon the outcome of the loan, which had been floated in extremely adverse circumstances, with satisfaction. But it had no desire to plunge into the market again during the year despite the government being substantially adrift of its borrowing target of Rs 250 crores in the concluding year of the second plan. In October 1960, officials in Delhi began sounding

out the Bank about the prospects of a second loan for Rs 70 crores. The Bank was firm in ruling out a further public issue because of the 'prevailing monetary stringency and the depressed state of the gilt-edged market'. Nor was it in favour of 'creating special issues of the existing loans in the absence of genuine investment demand as this would amount to issue of ad hoc securities'. 'We are doubtful if it will be possible to achieve the [market borrowing] target ... before the end of the financial year', the Bank told the government. The gilt-edged market remained in the doldrums throughout 1960-61. The public made net sales of government paper to the tune of about Rs 63 crores, while the Bank's net purchase of central government securities during the year was, at Rs 112 crores, overwhelmingly the highest of any in the period covered by this volume.

#### *Public Debt in the Third Plan*

As already pointed out, the Bank had some say, along with the Finance Ministry, in determining the third plan public borrowing estimates. Although the latter was, at Rs 850 crores, rather higher than it would have liked, particularly given the performance of central loans in the market in 1956 and 1957 and after October 1959, the Bank could take some satisfaction from the fact that it was considerably lower than the figure initially proposed by the Planning Commission.

The 1961 borrowing programme was drawn up against the background of the third plan exercises. While the Bank proposed a gross borrowing figure of Rs 200 crores for the year, the government preferred to peg the amount at Rs 225 crores in its budget estimates on the ground that there were heavy maturities in 1961-62 aggregating to Rs 139 crores. Of the latter, Rs 75 crores fell due at the beginning of June 1961, while the remaining amount was payable two months later. With May now firmly belonging to the extended busy season, a cash loan that month was more or less out of the question. Hence the Bank advised the government to issue a pure conversion loan in May, and follow it up with a predominantly cash loan in July. Thus towards the middle of May 1961 the government issued a tranche of 3.5 per cent National Plan Bonds 1967, the latter's issue price being adjusted to allow a slightly higher yield on the new loan compared to the current market yield on a corresponding maturity. The loan opened on 29 May. The Bank and the government would no doubt have preferred a better investor response, but the conversion loan was, on the whole, quite successful. Subscriptions totalled Rs 93.5 crores (or 69 per cent of the maturing loans as against the preceding year's figure of 65 per cent). In addition, maturing loans amounting to Rs 4 crores were offered for conversion when the predominantly cash loans were

floated in July. Of the loans offered for conversion in May, no less than Rs 65 crores were held by the Bank and the State Bank of India both of whom put up their entire holdings of the maturing stocks for the swap. The government accepted the Bank's advice concerning the terms of the conversion issue, but lengar felt in hindsight that a slightly higher redemption yield achieved through a further reduction in the issue price would have led to better results.

This hypothesis was put to the test when the cash loans were floated. The latter were in the form of a 3.5 per cent 1969 bond and a 4 per cent 1981 loan aggregating to Rs 100 crores, with this loan being so priced as to give a slightly higher redemption yield than the 4 per cent 1980 loan available in the market. Morarji Desai preferred a larger issue to enable the government to meet its public borrowing target for the year, but the Bank felt the gap could be made up later in the season, should market conditions so warrant, by a second loan. Subscriptions totalled Rs 109 crores, of which Rs 50 crores were put in by the Bank. Public subscriptions amounted to Rs 59 crores, more than half (or Rs 33 crores) in the 1969 bond. Taken together, the government's gross borrowings in 1961 amounted to about Rs 203 crores. This was about 10 per cent below the budget estimate of Rs 225 crores, but as the conditions in the market evolved, there was little the Bank or the government could do to take the public borrowing amount up to the budgeted figure.

Nor did the pressure ease the following year when maturities totalled over Rs 183 crores. This meant the government would have to float loans for Rs 250 crores to add Rs 67 crores to its borrowed resources only a year after it had failed to raise the budgeted amount of Rs 225 crores from the market. Though ambitious, officials thought a borrowing target of Rs 250 crores not altogether unrealistic since the Bank, the State Bank, and the state governments held between them about Rs 135 crores of the maturing loans.<sup>3</sup> With the busy season coming to a timely end, the Bank also decided in June that the entire amount should be raised in a single issue.

The large borrowing programme, however, necessitated a substantial increase in the structure of rates offered on central government loans, and this was the other major feature of the loans floated in 1962. When preliminary plans were made earlier in the year, the Bank proposed to issue a six-year loan maturing in 1968 at 3.5 per cent, a ten-year bond maturing in 1972 at 3.75 per cent, and a twenty-year 1982 loan at 4.25 per cent. By the time final proposals were prepared, the Bank came to the conclusion that some of these

<sup>3</sup> The market borrowing estimate in the budget was Rs 260 crores. Of this, Rs 10 crores were expected to be realized through the sale of prize bonds. After the budget was passed, the government decided to follow the Bank's advice and discontinue the existing prize bond scheme from July 1962.



rates would have to be increased. The main problem lay with the 1972 maturity. A 3.75 per cent loan, officials felt, would be uncompetitive if issued at par, while a competitive discount was likely to sharply upset the market quotations of the 3.75 per cent 1974 loan. A 4 per cent 1972 loan, in contrast, would have a more benign impact on the market (though it could compete with small savings schemes) besides proving popular with banks and provident funds. If there were strong objections from the government to offering 4 per cent on the 1972 loan, officials at the Bank felt, it would be preferable to 'drop the ten-year loan completely rather than offer one that is not likely to prove popular and the bulk of which we may have to carry in our portfolio'. On further consideration, the Bank also came to the conclusion that a 3.5 per cent 1968 loan too could prove unpopular, particularly if the 1972 loan carried a 4 per cent rate, since there was already a 3.75 per cent 1968 scrip in the market. Officials in Bombay, Delhi, and Washington acknowledged that higher coupon rates would also smoothen the passage of India's application for a Fund standby, and the Bank advised the government that the most 'realistic approach under the conditions now prevailing' was to raise the interest rate offered on the six-year and the ten-year loan by a quarter of one percentage point, to 3.75 per cent and 4 per cent respectively. The 4.25 per cent rate on the 1982 loan, it felt, was adequate to attract the Life Insurance Corporation, the provident funds, and trusts who would, in fact, welcome the step-up in the yield on the long loan (the current yield on the 1981 loan being 4.11 per cent) more than complain about the inadequate spread between the medium-dated and the long-dated loans.

In the end the Bank and the government agreed on a slightly longer loan of 23 years rather than the 20 years proposed earlier, with the new 1985 loan offering 4.5 per cent. Both the Bank and the government had been concerned for some time past to stretch out the maturity pattern of the latter's obligations, and besides possessing the advantage of being more competitive, the 4.5 per cent rate enabled the government to offer in the market loans having the longest maturity of any issued since 1946. Thus, apart from featuring the largest single issue until then of Rs 250 crores (the previous highest being the Rs 175 crores floated in 1959-60 and 1960-61), the 1962 loan programme saw a fairly radical leveraging up of the interest rates offered on central government loans. These two features were not obviously unrelated, the Bank and the government recognizing that the ambitious loan programme would not succeed at lower rates. But as we will see below, even these new rates soon began to appear modest in the light of subsequent developments.

The 1962 loan, which was floated towards the middle of July, attracted total subscriptions of about Rs 257 crores. Of this Rs 154 crores, which was

Rs 6 crores more than the Bank's most hopeful estimate, was in the form of conversion, and the remainder in cash. The Bank's cash contribution amounted to Rs 30 crores which was substantially lower than the Rs 50 crores it had contributed to ensure the success of the much smaller loan programme undertaken the previous year. Of particular note, subscriptions to the new 23-year, long-term loan aggregated Rs 84 crores, which was more than those to the ten-year loan (Rs 81 crores) and not much short of the amount raised by the short-dated loan (Rs 92 crores). Taking 'all factors into account', the Bank informed the government in July 1962, 'the loan operations this year could be judged as satisfactory'. This, almost formulaic, sentence which figured with astonishing regularity in the letter the Bank wrote to the government at the conclusion of its loan operations each year was, given the challenge of the 1962 programme, something of an understatement.

The central government's loan programme for 1962, which was earlier thought to have been put to bed after July's successful issue, had to be unexpectedly revived in November in the wake of the border conflict with China, and a medium-term, ten-year loan was floated to help finance the additional expenditure on defence. Carrying a 4.25 per cent rate, offered at par, and kept on tap until 29 April 1963, the National Defence Bonds helped raise Rs 28 crores for the government. At the same time, the government also floated the 6.5 per cent Gold Bonds, 1977. Intended to translate the public outpouring of patriotic sentiment into financial resources to help fight threats to the country's security, subscriptions to these bonds were to be in the form of gold, gold coin or gold jewellery. Redeemable at par after fifteen years, the bonds carried an interest rate of 6.5 per cent. Gold tendered to the government under the scheme was in effect valued at the official (IMF) gold price of \$35 per standard ounce, and the higher interest rate offered under it was intended to take account of the premium on the metal in the domestic market. Total contributions to the loan, which too was kept on tap until the end of February 1963, amounted to about 16 million grams or about Rs 8.7 crores at the international price.

Shortly after the Chinese aggression, the National Development Council decided to combine the market borrowings of the central and state governments in 1963 in order to 'mobilize maximum resources for meeting the present emergency ....' Subsequently, the Finance Ministry decided in consultation with the Bank to raise Rs 400 crores (including Rs 100 crores for state governments) from the market during 1963-64. From its past experience, the Bank was not enthusiastic about the idea of a combined loan. The Deputy Governor, M.V. Rangachari, exploited an opening presented by an ambiguous reply the Deputy Finance Minister gave in response to a parliamentary question



Union Finance Minister Morarji Desai inaugurating Premium Prize Bonds in New Delhi, 1 January 1963

to impress upon the government even as late as March 1963, that there was a 'very strong case' from the 'practical point of view' and from that of 'mobilizing more resources' to preserve the existing arrangement whereby state governments came to the market separately for their requirements since it ensured that the latter took some interest in making their issues 'as much of a success as possible'. State governments did not 'take the same interest when only a Central loan is floated although part of the proceeds are handed over to them'. Besides, the higher rate offered on state loans acted as an inducement to commercial banks who supported state loans 'to a very much larger extent than ... the Central loan'. But the government decided to stick to the course determined by the National Development Council for 1963, especially since in the meantime state governments too had come generally to accept the proposed arrangements.

The Bank favoured a two-stage loan programme to raise the budgeted amount from the market. Since two Government of India loans aggregating

about Rs 176 crores were falling due at or before the beginning of June, it suggested a conversion issue in May of a short-dated six-year loan—one of the two maturing central loans (amounting to about Rs 58 crores) dated back to 1938 and its holders were thought likely to convert to short-dated stock or not at all—and a long 23-year loan. The conversion issue was a success. Subscriptions amounted to nearly Rs 139 crores, of which about Rs 86 crores were in the short loan and the remainder in the longer-dated stock. The response to the conversion offer was particularly good from holders of the stock floated in 1938, with conversions effected totalling over Rs 50 crores.

When the time came to finalize proposals for raising the cash tranche of the combined governments' borrowing for the year, the Bank took the view that the issue should be limited to Rs 225 crores, with a further tranche being issued later in the season should conditions in the market warrant it, to raise the aggregate of loans during the year to the budgeted amount of Rs 400 crores. The two cash-cum-conversion loans which were floated in the second half of July 1963 did not set the markets on fire. Unlike in 1954, the government decided against mobilizing the Prime Minister for the loan campaign, but Morarji Desai wrote personally to chief ministers of states requesting them to take 'suitable steps on the usual lines' to attract subscriptions and secure the support of major institutional investors in their areas. Despite Desai's efforts, total subscriptions amounted only to about Rs 146 crores, of which more than half was for the short-dated loan. The Reserve Bank therefore put in Rs 80 crores divided equally between the two loans in order to close the lists only a day before they were officially scheduled to close. As Rangachari confessed to L.K. Jha after the close of the loans, while the expectations the Bank and the government held from the public did not materialize, 'our fears that ... state governments would not take much interest as they do when state loans are floated separately appear to have been justified'.

Total subscriptions to the combined loans floated in 1963 aggregated to Rs 365 crores, comprising Rs 207 crores in cash and Rs 158 crores in conversion. To this may be added the Rs 6.13 crores collected by the government through the 4.25 per cent 1972 loan which was kept on tap. The centre allocated about Rs 100 crores out of the resources it raised to the states in the form of ten-year loans, the share of each state being determined generally on the basis of the gross amount borrowed by it from the market in the preceding year.

Although the net borrowings of the central government were considerably higher at Rs 143 crores in 1963 compared to the Rs 73 crores raised in 1962, it was still some Rs 35 crores short of its borrowing target. The government had initially accepted the Bank's advice on the size of the second issue on the

condition that 'every possible effort' would be made to float an additional tranche later 'so as to reach the budgeted target, if not actually to exceed it', but did little following the failure of the combined issue to follow up proposals for a third issue.

Despite the failure of the combined loan floated in 1963, the central government was not keen to revert to the earlier arrangement of floating separate central and state loans. A background note prepared by I.G. Patel, the Chief Economic Adviser to the Government of India, for a conference of finance ministers of states held in November 1963 argued for a permanent arrangement in which the centre undertook all general purpose market borrowings, while the states borrowed for specific purposes on behalf of institutions under their control. In return, the centre would share the loans it raised with the states and give them a higher share of collections of small savings. This arrangement, Patel argued, would make for better management of the public debt and monetary control, besides more clearly defining the responsibilities of institutional investors such as the Life Insurance Corporation in relation to the government's borrowing programme.

The Bank objected to these proposals on several grounds. Besides being inconsistent with the constitutional provisions governing the borrowing rights of states, Patel's plan overlooked differences in credit ratings between the central and state governments on the one hand and among state governments on the other, as well as the fact that many investors preferred state loans to those of the centre because of the higher coupon rates they carried. Nor would state governments as past experience showed, take much interest in the fate of a combined loan while straining every nerve to make a success of their individual loans. In addition, the Bank apprehended that Patel's proposal would require it to make larger contributions to ensure the success of loans issued in the future: while it followed the practice of making up the entire shortfall in public contributions to central loans, the Bank's contribution to state loans was limited at that time to 10 per cent of the issued amount.

The central government did not, in the event, press its point of view, and 1964 marked a return to separate loan flotations. With maturities during the year amounting to Rs 192 crores, the Bank proposed to the central government a borrowing target of Rs 275 crores in 1964-65. Although even this, as the government conceded, was 'somewhat optimistic', it felt compelled to increase the figure to Rs 295-300 crores 'purely for budgetary purposes'. On the other hand, the new statutory liquidity requirements slated to come into effect from September could be expected to create some additional demand from banks for government securities. With the bulk of the maturities falling due in April

and June, the Bank once again decided to float a conversion issue comprising a short-dated, six-year loan at 4 per cent and an issue price of Rs 99, and a 25-year loan at 4.75 per cent issued at par. There was, in the Bank's view, 'not ... much demand for a medium-dated loan', and nothing would be lost in 'leaving it out for the time being'. The issue floated in April proved quite successful, with maturing loans to the tune of nearly Rs 142 crores (out of a total of about Rs 192 crores) being offered for conversion. This was followed by a cash issue for Rs 150 crores of the same loans on identical terms in July, which netted nearly Rs 152 crores (of which Rs 67 crores were subscribed by the Bank) and took the central government's market borrowings for 1964-65 to Rs 294 crores.

The central budget assumed gross borrowings of Rs 270 crores for 1965-66 which was the terminal year of the third plan. This was subsequently slashed to Rs 250 crores, and an issue comprising two loans—a six-year 4.5 per cent 1971 loan issued at Rs 99.50 and a 25-year 5.5 per cent 1990 loan issued at par—was floated in June 1965. The issue netted Rs 251 crores, of which Rs 124 crores were in cash. Although the Finance Minister had declared in his budget speech the government's intention to reduce, if not eliminate, its dependence on Reserve Bank support to its loan programme, the latter's cash contribution to the 1965 loans amounted to Rs 66 crores. This was not by any means the largest contribution the Bank made in absolute terms to a central loan—that distinction belonged to the Rs 80 crores it put up for the combined 1963 loan and only the previous year the Bank had subscribed Rs 67 crores in a total cash loan of Rs 152 crores—but it represented the largest proportional contribution by the Bank to a publicly floated central loan in recent times. The Bank had also put up Rs 98 crores of the securities amounting to Rs 127 crores offered for conversion, so that over Rs 164 crores out of the government's total gross borrowings of Rs 251 crores in 1965 were contributed by the Bank. Further, unlike in 1964 when the Bank managed to sell loans issued to it during the year to the tune of Rs 106 crores, the corresponding figure for 1965 amounted only to about Rs 35 crores, while its net sales of all term loans during July 1965 to March 1966 did not exceed Rs one crore.

The central government was obliged to return to the market in October 1965 to mobilize resources for the defence effort. Two National Defence Loans, of three and seven years' duration, carrying interest rates respectively of 4.25 per cent and 4.75 per cent were issued on tap. Subscriptions in cash to these loans, which were promoted by Prime Minister Lal Bahadur Shastri in a radio address to the nation, and by a letter from the Governor, P.C. Bhattacharyya, to chief ministers of states, amounted to Rs 28 crores. In addition, the government floated a fifteen-year Gold Bond, subscriptions to

which were once again in the form of gold, gold coin, or gold jewellery, and attracted a nominal interest of Rs 2 per year for every ten grams of gold. Kept on tap for three months, Gold Bonds mobilized 13 million grams of the yellow metal.

Casting the 1966 borrowing proposals in the background of its inability to unload any significant proportion of its stocks of gilt-edged paper in the market during 1965-66, the Bank proposed to the government a gross borrowing target of Rs 225 crores for the year. But, as an office note remarked, the Bank and the government 'pull[ed] in different directions', with the latter proposing a gross borrowing target of Rs 300 crores. This was subsequently scaled down to Rs 280 crores, of which Rs 130 crores were expected to be in the form of cash. Officials at the Bank felt the government's borrowing target would not be met unless the Bank itself subscribed Rs 65 crores to the cash portion of the loan. This, as the Deputy Governor, B.N. Adarkar, remarked, violated the 'general tenor' of the Bank's credit policy. 'If deficit financing is to be restricted', he argued, the government would have to 'adjust ... [its] borrowing programme accordingly'. Suggesting a borrowing figure of Rs 250 crores, Bhattacharyya felt he could not 'justify the R[eserve] B[ank] putting another [Rs] 65 crores this year when we have not been able to unload any securities subscribed last year'.

In the end, the Bank and the government decided to float loans totalling Rs 260 crores. This issue, which was floated in July 1966, proved unexpectedly successful. Total subscriptions amounted to Rs 275 crores, of which nearly Rs 127 crores were in cash. Thanks to the larger than expected subscriptions of the State Bank, its subsidiary banks, other commercial banks, and state governments, the Bank's cash contribution could be held in check at Rs 37 crores.

#### *Parliamentary Control over Government Borrowing*

The role and the rights of Parliament in relation to the public borrowing programme of the central government came up repeatedly for discussion during these years. Apart from being raised in the form of questions or figuring prominently in Parliamentary debates, the Estimates Committee and the Public Accounts Committee also devoted some thought to giving effect to the provisions of Article 292 of the Constitution empowering Parliament to fix limits on the borrowing powers of the central government.<sup>4</sup> The government

<sup>4</sup> Article 292: 'The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees, within such limits, if any, as may be so fixed.'

generally took the view that while permitting the enactment of a law fixing borrowing limits, Article 292 did not mandate it. Parliamentary approval was sought and obtained for the five-year plan and the annual budgets, both of which gave details of the manner in which the government hoped to finance itself during these periods. Not only was further legislation therefore unnecessary, it was also unlikely to provide any 'real checks': while narrow limits would be 'impracticable', 'wide limits' would not 'offer any additional safeguards' against profligacy.

The Bank was generally content, whenever consulted, to go along with the government's view. The issue arose in 1958 of the rights of Parliament to be informed of the terms of central government loans and of the details of subscriptions to them. A report of the Estimates Committee of Parliament dealing with budgetary reform proposed that the government should submit to Parliament details of its borrowing programme both before and after it approached the market each year. The Finance Ministry was averse to the suggestion. Borrowing, it argued, was an 'executive function' and it was not 'practicable to go to Parliament every time a loan is ... raised'. Besides, the details and timings of loans were matters of 'high secrecy' which could not be divulged to Parliament in advance. However, the ministry had no serious objection to laying before the two houses, from time to time, a report on the results of government loans, and sought from the Bank its advice on the 'form and contents' of such a report.

The Bank agreed that there was no question of informing Parliament of the details of loans before they were floated. But it might often (though not always since Parliament was not in session continuously) be possible to table copies of loan notifications during the interval between their publication and the loans opening. The Bank also agreed with the Finance Ministry that it would not be 'desirable to disclose to Parliament any further details beyond what we now publish', i.e. total subscriptions in cash and conversion separately for each loan.

If we were to start giving particulars of subscriptions by certain categories such as banks and insurance companies ... it will not be possible to withhold effectively information regarding our own subscriptions.

The Bank subscribed large amounts to central loans and expected to continue doing so 'in the next few years because of the exigencies of planning'. But a large part of this was later sold in the market to banks and other investors. Publishing details of subscriptions to central loans, the Bank argued, would



only present a 'misleading picture' of the pattern of demand for government securities during the year and 'adversely affect the response from the market to new loans ....'

In 1964, the issue of statutory control over government borrowings came up more directly in a report of the Public Accounts Committee of Parliament. While the Finance Ministry was inclined to reiterate its previous views, there was a noticeable shift in the Bank's approach towards the subject. According to the Bank, it was not

realistic to assume that it will be possible to resist for all time the demand from Parliamentary Committees that a specific provision in the Constitution although ... not worded mandatorily should not be allowed to remain a dead letter.

Hence, while 'for the moment we may press for the maintenance of the status quo', the government should also give 'careful thought' to recognizing more explicitly the principle of Parliamentary sovereignty over government borrowing.

### TREASURY BILL OPERATIONS

Treasury bills accounted for about a fifth of the rupee debt of the Government of India in March 1967. Bills with maturities of six months, nine months, and one year were first issued in India in October 1917, and 91-day bills were introduced at the beginning of the following year. Intermittently, bills with a currency of four months and eight months were also floated to spread maturities more evenly through the year. Soon after its inauguration in April 1935, the Bank took over the issue of treasury bills from the Government of India.

Except for a brief interval of three years between 1924 and 1927, treasury bills were sold in the market every year between 1917 and 1949. Following the inauguration of provincial autonomy, the Bank also began selling treasury bills on behalf of some provincial governments from April 1938. Sales of central government treasury bills were suspended after the auction of 20 December 1949 'as there were no tenders either from banks or the public'. The Imperial Bank of India, which was the main investor in these instruments, quoted 'extremely stringent money market conditions' as the reason for withdrawing its support. The practice of issuing treasury bills on behalf of state governments was discontinued from January 1950 and never resumed. The question of reviving central government treasury bill auctions was considered within the Bank and in consultation with the government at regular intervals thereafter, but a decision was put off for one reason or the other. The

idea was cautiously promoted in August 1951, only to be abandoned almost immediately.

The following April, however, the Bank began to examine the possibility of resuming treasury bill auctions more seriously. As a note by S.L.N. Simha argued, the open-market policy announced in November 1951 increased the necessity of making available to banks 'a short-term asset ... of a self-liquidating character ... on which they could readily obtain accommodation from the Reserve Bank'. Officials in the upper echelons of the Bank were also more favourably disposed to the suggestion now than before, Sundaresan for example, recording his view that treasury bills should now be 'one of the permanent features of ... [Indian] public finance', and it was tentatively agreed to revive treasury bills sometime during the slack season. The proposal was discussed between Rama Rau and Deshmukh in August 1952. The former cited the government's comfortable cash balance position to justify his own preference for six-month and nine-month bills. Three-month bills which banks were unlikely to renew, he felt, offered few 'compensatory advantages' for the government. Deshmukh however argued that three-month bills were essential for the success of the 'treasury bill system' even if it was introduced on an 'experimental scale', and he and the Governor agreed to the issue each week from early September, of treasury bills for Rs 3 crores split equally between bills of three-month, six-month, and nine-month maturities. The latter two categories of bills, they expected, would replace Government of India treasury deposit receipts of similar currency which were on offer to banks and their constituents.

The first auction of treasury bills since 1949 took place on 9 September 1952. In the event, the Bank decided to float only three-month bills at the outset for fear that their simultaneous issue may 'result in a somewhat anomalous alignment of discount rates between the various maturities'. It was also resolved to limit the issue to Rs 2 crores each week and not to issue intermediates 'till we [have] gain[ed the] experience'. As a further step to encourage the demand for them, the Bank decided to rediscount treasury bills at a concessional rate of half an anna above the average rate of the auction at which the bills under negotiation were issued. The earlier practice in this regard was to discount treasury bills at an anna above the average rate for them at the last weekly auction, subject to a minimum interest of half anna per cent.

After some discussion as to rates, the Bank decided to 'start with 2 per cent ... and build up ... gradually'. To begin the programme with a higher rate, Sundaresan felt, 'would lead to unnecessary speculation as regards money rates in the ensuing busy season'. The Bank was able to hold down the rate and yet raise short-term funds for the government thanks to an unusual

arrangement with the Imperial Bank which sent each week 'a blank signed tender for Rs 2 crores to be used at ... [the Bank's] discretion'. Thus at the first auction on 9 September, both the Imperial Bank and the Bank of India put in tenders for Rs 2 crores each and the Bank of Baroda for Rs 50 lakhs. The first-named bank quoted a floor price of Rs 99-8 (its tender at this auction left only the paise entry blank; this quote accorded with a maximum discount rate of Rs 2 per cent), while the price quoted by the latter two institutions varied between Rs 99-5 and Rs 99-6-6, corresponding respectively to discount rates of Rs 2-12 per cent and Rs 2-6 per cent. That the average rate of accepted tenders at this auction was held down to Rs 1-15-11 per cent reveals the extent to which the Bank's arrangement with the Imperial Bank allowed it to sway the market. Thanks too, to this arrangement, the rates at which other banks tendered for treasury bills firmed up and the difference between their rates and that offered by the Imperial Bank narrowed at subsequent auctions. But the average discount rate increased gradually to Rs 2-1 per cent by early October 1952 as the Bank itself priced the Imperial Bank tender at Rs 99-7-9 against the Rs 99-7-6 quoted by the Bank of India which was the only other major bank left at the auction.

When the treasury bill programme resumed, the Bank had hoped to issue six- and nine-month bills at fortnightly and monthly intervals, but plans for them were put on hold indefinitely. At least part of the reason for this was the tepid response the auction of three-month bills evoked in the market. After six weekly issues aggregating to Rs 12 crores, the Bank noted that treasury bills were 'still not popular with institutional investors'. There was little interest from banks other than the Imperial Bank of India which as we have already noted bid under a 'special arrangement', since they were 'able to lend money outside on better terms'. Even the Imperial Bank which accounted for the overwhelming bulk of the treasury bills issued (over Rs 19 crores of the Rs 28 crores issued until 9 December 1952), moved to limit and eventually end its support. With money getting tighter in the market, and the demand for treasury bills falling, the Bank suspended their sales for two weeks at the end of December 1952. There was little improvement in demand when auctions resumed early in January 1953, and the Bank considered holding auctions 'in abeyance for the next six weeks'.

That this decision was not finally taken owed to Rama Rau's success in persuading Roderick Chisholm, the Managing Director of the Imperial Bank, to continue tendering Rs one crore at each weekly auction of treasury bills. The Imperial Bank, Rama Rau and Chisholm agreed, 'will, if necessary, rediscount bills, but will not discontinue tenders'. Unless the treasury bill programme was continued in the busy season, Rama Rau argued, 'we would

be merely paying interest during the slack season on the surplus balances of the Imperial Bank and the other banks ....' The programme was thereafter limited to Rs one crore each week, but even at this reduced level of offerings the average rate climbed to Rs 2-7 per cent in the auction conducted on 21 January 1953. Seeing that the average rate had risen from Rs 2-3 within two months despite the reduction in the meantime in the size of the weekly programme, Deshmukh wondered whether it was 'worthwhile taking money' at the higher rate and whether 'Rs 2 ... was not a suitable maximum'. An official of the Finance Ministry remarked to Sundaresan:

We seem to be getting all the money only from the Imperial and I do not know if it is not merely transferring to Government the balance they otherwise keep with the Reserve Bank.

However, in the consultations which followed between the Governor and the Finance Minister, the latter agreed to the treasury bill rate being put up to about 2.5 per cent during the busy season.

Thereafter auctions of treasury bills continued practically without any interruption for over three years, though largely on the strength of the Imperial Bank and later the State Bank of India putting in a tender for the entire amount on offer at each weekly auction. But with conditions in the money markets becoming very stringent, 'banks ... not evincing interest in these bills', and even the State Bank immediately rediscounting the bills allotted to it in order to 'get a better return ... elsewhere', it was decided to discontinue the auction of treasury bills in April 1956. At this time the admittedly 'artificial' average rate of accepted tenders varied between Rs 2-8-1 and Rs 2-8-6.

Treasury bills were not issued for over two years until the end of July 1958. In November 1957, some bankers urged the Bank to resume treasury bill auctions on the plea that selective credit control measures and the general increase in their deposits had left banks in a 'comfortably easy cash position'. Although it harboured serious misgivings about allowing, as suggested, an average rate on accepted tenders of about 3.5 per cent, the Bank was attracted to the principle of resuming treasury bills auctions, partly no doubt because the 'creation of ad hocs [would] be reduced' thereby. The State Bank was consulted, and it too indicated that the government could 'safely count on [its] ... support' to the programme for six months to a year. But in the end the proximity of the approaching busy season and fear that the instrument would not appeal to investors unless it offered about 3.5 per cent discouraged the Bank from pursuing the bankers' suggestion. A 3.5 per cent rate would mean the Bank 'giving recognition to higher short-term interest rates. I do not think

that we should play such a role', Ambegaokar remarked. Instead, the short-term investment problem of the State Bank and some other banks was solved, as pointed out above, through the issue of a special tranche of the 3.25 per cent 1962 loan.

However, within a few months in June 1958, the Bank was persuaded by the early commencement of the slack season, rapid growth in the resources of the banking system, the steady demand for government securities, and the firm tone prevailing in the gilt-edged market to propose resuming weekly treasury bill auctions. Should these bills be issued now, Ambegaokar wrote to Rangachari, 'they [would] be keenly sought after ... during the busy season also'. The early offerings, he suggested, could be made at about 3.25 per cent with the rate being 'tapered down' in subsequent weeks to 3 per cent. The government accepted the Bank's suggestion and after July 1958 auctions of treasury bills were conducted more or less regularly until July 1965 when they were placed on tap, even though the State Bank of India was often the only bidder. A memorandum to the Committee of the Central Board prepared at the end of 1961 in response to queries about the programme from K.C. Mahindra and R.G. Saraiya justified the persistence on the ground that

auctions [of treasury bills] were held not for raising funds for the central government but to induce banks to hold these bills in their investment portfolio ... [and] creating a taste for them.

The Bank also maintained rather disingenuously that regular treasury bill auctions represented another step towards creating a bill market to supplement

the Bank's scheme of discounting trade bills for scheduled banks. It is for this reason that, unlike in the past, the weekly auctions have not been suspended even after the onset of the busy season.

Finally, though it was often the only bidder, the State Bank did not always rediscount these bills nor complain that the programme was in any way 'inconvenient' to it. 'In these circumstances and having regard to the object in view', the memorandum remarked, 'it does not appear necessary to discontinue the weekly auctions'.

Over two years later, in April 1964, the Government of India grew 'somewhat perturbed over the precipitate increase' in the rate of interest on treasury bills from 2.3 per cent before the auction held on 17 March to 3 per cent a fortnight later. Conveying the Finance Minister's disquiet, an official of the Finance Ministry wondered whether the time had not come to suspend treasury bill sales at least so long as the busy season lasted. The Bank pointed out in response that it was 'unrealistic to expect any one (except the State

Bank who do it to assist the bill market ...) to put their money in treasury bills' when the inter-bank rate ruled at over 6 per cent and banks paid out 3 per cent on call money. The Bank had allowed the rate to rise to 3 per cent after 'very careful thought' since it was convinced that it was 'in all the circumstances ... the proper rate'. 'We do not think that the auctions should be discontinued', Rangachari, who was now a Deputy Governor, also advised the government.

For about five years in the late 1930s and the early forties, the Bank had also sold 'intermediates' between weekly auctions of treasury bills. Made available from the day following one weekly auction until a day before the next, 'intermediates' were offered at a price which was usually three pias above that at which the bulk of the tenders were accepted at the preceding auction. The most important advantage of intermediate bills was that they provided an elastic means to relieve the market of surplus funds while allowing the central government to obtain, within limits, larger funds without forcing the discount rates upwards. In October 1958 the Bank took up the question of reviving 'intermediates' which were last suspended in July 1943, against the background of the 'large surplus funds' accruing to the State Bank of India in the form of P.L.480 deposits. While the State Bank, citing the impossibility of anticipating the demand for funds in the busy season and the uncertainty as to interest rates, wanted to invest the bulk of these resources in 91-day bills, there was little prospect of weekly auctions of treasury bills meeting its entire requirements. As it happened, the State Bank invested its balances not in intermediates, but in a special class of 'ad hoc' treasury bills created as necessary and sold at the same rate as 'intermediates'.<sup>5</sup> But the Bank was persuaded by the excess demand which prevailed for treasury bills at this time—tenders received totalled Rs 8.75 crores against an issue amount of Rs 3 crores in the concluding October auction—to resume the sale of intermediate treasury bills in November 1958. The demand for these bills remained disappointingly small, however, total sales amounting only to about

<sup>5</sup> These bills, which also had a currency of ninety-one days, were created in favour of the Bank and sold thereafter at a small commission to state governments and government departments having excess cash balances and to some foreign institutions such as the Central Bank of Ceylon and the State Bank of Pakistan. They were sometimes referred to as 'special ad hocs' to distinguish them from the ad hocs issued to the Bank by the central government to finance its ways and means. The underlying object of creating 'special ad hocs' was to eliminate sharp fluctuations in the demand for treasury bills at the weekly auctions. As discussed below, the distinction between special ad hoc treasury bills, intermediates, and treasury bills disappeared after the latter were placed on tap in 1965.

Rs 5 crores when they were put back on the shelf early the following month. Thereafter the Bank sold intermediates, sometimes in substantial quantities, at rather irregular intervals.

In July 1965, the Bank moved towards placing 91-day treasury bills on tap. The decision arose partly from the Bank's concern to promote the treasury bill market more actively in the slack season as a means of diverting banks' surplus balances from the inter-bank market. Bankers told the Governor, P.C. Bhattacharyya, when he raised this subject with them at a meeting in May 1965, that they found treasury bills unattractive because these were not available throughout the week. Besides, they argued, the tender system made for low slack season rates. There was also apparently some suspicion in the market that the Bank was itself ambivalent at best in its attitude towards rediscounting treasury bills. Overcoming considerable internal scepticism and in an effort to make treasury bills more attractive to banks, the Bank decided to offer the asset on tap throughout the week at rates determined each Monday on the basis of call money conditions during the preceding week. The formal decision to place 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. Bhattacharyya called another meeting of chief executives of banks in June 1965 to persuade them to put their funds in treasury bills.

Thanks to these efforts, 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.) Scheduled banks' outstanding stock of these instruments also rose nearly fourfold from Rs 5.31 crores at the end of March 1965 to Rs 20.1 crores at the end of March 1966, or from one per cent to 2.4 per cent of their total investments in government securities. By 1966, banks themselves began pressing the Reserve Bank and the government to begin issuing 180-day treasury bills. The Bank too was disposed to believe the new system of tap sales of 91-day treasury bills was a success, and responding to bankers' suggestions, it drew up a scheme to offer six-month treasury bills on tap 'as a convenient instrument for banks to hold during the slack season ....'

#### AD HOC TREASURY BILLS

It was pointed out in an earlier chapter that following an exchange of letters with the Government of India in January 1955, the Bank agreed without much thought to top up the latter's balances whenever they fell short of Rs 50 crores at the end of any week. Thanks to this agreement, an enabling provision in the Bank Act—section 17(5) which authorized the Bank to make to the

'Central and State Governments ... advances repayable ... not later than three months ....'—became converted into a mandate.<sup>6</sup> The advances so made were matched by the issue to the Bank of ad hoc treasury bills which were held in the Issue Department. While it was customary for a central bank to make temporary short-term advances to the government to cover mismatches between the flow profiles of the latter's receipts and expenditures, the practice which was made routine in 1955 gave the central government virtually unlimited right of borrowing from the Reserve Bank. We have also observed that soon after taking up office as Governor, Iengar alerted the Finance Minister, T.T. Krishnamachari, to the dangers of the prevailing practice. But the minister rejected subjecting the financing of government to any 'rigid procedure' and merely agreed to consult the Bank about the government's borrowing and ways and means requirements.

Consultations, if any, were desultory, with the Finance Ministry merely supplying to the Bank each month its ways and means forecasts and estimates of the volume of ad hoc treasury bills it expected to issue during the month. Even such 'consultations' soon ceased. But the Bank never stopped replenishing the balances of the government in the manner agreed in 1955. In what had become a well established routine even by 1957, the Bank itself created ad hoc bills to the extent indicated by its principal client's balances each week and merely informed the government of having done so. Apart from these routine credits, the Bank also created additional ad hoc treasury bills at the government's instance whenever the latter felt the need to hold larger cash balances. By March 1958, despite misgivings about this method of financing the central government's budgetary outlays, the Bank grew reconciled to the 'realities of the situation', viz. that ad hocs represented 'in fact a permanent debt of the Government which would not be repaid ordinarily'.

Not surprisingly in the circumstances, the average net volume of ad hoc bills issued by the government ballooned from Rs 50 crores per annum during the first plan to Rs 189 crores per annum in the second, before falling to Rs 160 crores per annum during the third plan years. However, in 1966–67 the net volume of ad hoc bills created rose sharply to Rs 260 crores (table 9).

<sup>6</sup> The Hilton Young Commission (1926) which first officially recommended the establishment of the Reserve Bank had proposed allowing the new institution to make advances to the government repayable within three months of the end of the financial year in which they were made. The Select Committee on the Reserve Bank of India Bill felt besides being too liberal, the original provision would encourage the government to take 'undue latitude' with these advances, and limited their currency to three months.



*Funding Ad hoc Treasury Bills*

On the other hand, ad hoc bills to the tune of Rs 825 crores were 'funded' into dated securities between July 1958 and March 1967. The idea of funding ad hoc treasury bills first originated with the Bank early in 1958. The immediate practical object of the Bank's suggestion was to redress the imbalance in the domestic assets portfolio of its Issue Department which now overwhelmingly comprised ad hoc treasury bills. At regular intervals since April 1956, the Bank had faced the problem of finding eligible assets against which to expand currency. But the present embarrassment arose because the central government's balances during the preceding months were 'replenished on a much higher scale than the [public's] demand for additional currency', and dated securities transferred to the Banking Department to balance the assets and liabilities sides of the Issue Department's books. Transferring foreign assets from the latter department to the former was ruled out initially because the income on sterling assets (which made up the overwhelming part of India's foreign assets) held outside the Issue Department attracted UK income tax. After this hurdle was removed, the Bank began to feel uneasy about lowering the Issue Department's holdings of foreign assets to the statutory minimum and thereafter expanding currency solely against ad hocs whose availability was now the only certain factor of the situation.

The Bank also considered the possibility of holding ad hoc treasury bills in its Banking Department. But its auditors ruled that ad hocs would have to be held as 'bills purchased and rediscounted' rather than as 'investments'. In August 1956, as pointed out in chapter 2, Ambegaokar overruled the warnings of the economists to endorse the idea of persuading the central government to issue ad hocs in excess of its own cash requirements to enable the Bank to expand currency. But in 1958 V.G. Wagle, author of the idea Ambegaokar had carried to Delhi some eighteen months earlier and now the Bank's Deputy Chief Accountant, disapproved of extending loans to the government from the Banking Department against ad hocs which 'would not be repaid'. To the Bank's economists, however, the problem raised by Wagle was merely presentational, and there was no difference between ad hocs held as 'bills purchased and discounted' in the Banking Department and as 'Government of India rupee securities' in the Issue Department. If anything, the Economic Adviser, B.K. Madan, may have found the former course more attractive because of the transparency it might lend to the Bank's financing of the central government.

Nor did other solutions considered earlier when the Bank faced a shortage of eligible assets for the Issue Department appear to hold much promise in 1958. The plan to buy gilt-edged stock outright from the market, rather than

lending to banks against their security, evoked little support because it would have meant unwarrantedly altering monetary conditions to overcome an accounting problem. The latter drawback did not affect a scheme the Bank finalized in January 1957 to rediscount bills under the bill market scheme instead of making advances against them, so that such bills could be held as section 17(2) assets in the Issue Department, but little was heard of it in March 1958. There was some support in 1955–56 for abolishing the distinction between the Bank's Issue and Banking Departments. The Bank considered abolition again in March–April 1958 at the central government's instance. But officials at Mint Road now resisted the suggestion since it would be 'interpreted as a method of whittling down the provisions regarding the cover for the note issue'. In any case, neither the Bank nor the government particularly wished at this time to face Parliament with another bill—the third within three years—to amend currency cover provisions either directly or indirectly. Abolition, moreover, would not eliminate the need for funding ad hocs since it was 'not quite appropriate' for the Bank to hold three months' treasury bills which have to be 'perpetually renewed'.

On the other hand, with the Issue Department's cupboard of dated securities virtually bare, some action was urgently called for. Funding, as Madan and Simha proposed, was the most attractive option. The government was initially unenthusiastic, and differences developed, besides, over the details of funding operations. The Bank was in favour of creating a further tranche of an existing, quoted, non-terminable loan against about a third of its holdings of ad hoc treasury bills of Rs 875 crores. North Block opposed funding the government's ad hoc short-term liabilities into existing loans for fear of depressing gilt-edged prices, and preferred converting them into special non-terminable loans carrying low rates of interest. But the Bank argued against this course: such loans, it pointed out, would not be quoted in the market and could not be held in the Issue Department without an amendment to the Reserve Bank of India Act.

In the end North Block came round to the Bank's point of view, and Jawaharlal Nehru's speech presenting the 1958–59 budget affirmed the government's intention to begin funding its floating debt. Mint Road now proposed funding ad hoc bills of Rs 300 crores into a 3 per cent non-terminable loan then quoting at Rs 71 in the market. But Finance Ministry officials objected to issuing further quantities of a loan quoting at Rs 71 since it meant creating securities of the nominal value of about Rs 422 crores, treating the difference (of Rs 122 crores) as a discount in the books of accounts, and an addition of Rs 5.5 crores to the government's interest

liabilities. Officials in Delhi instead preferred funding the floating debt into a loan which was at or close to par, and after some discussion it was finally decided to issue to the Bank in July 1958 a fresh tranche of the 4 per cent long-term loan floated with moderate success some weeks earlier. One of the conditions of the operation was that the Bank would transfer to the government in the form of higher profits, the additional interest (amounting to Rs 4.5 crores) it earned on these assets. At the time that this operation was carried out, dated securities accounted for only one per cent of the assets of the Issue Department.

Attitudes within the Bank to funding operations remained somewhat mixed during the next few months. Ambegaokar argued for example that funding increased the cost of government borrowing without conferring any advantage on the Bank since in addition to making additional depreciation provisions in the wake of large-scale funding operations, the latter would have to carry in its books assets which were far from liquid. Funding, he suggested, was more suited to the object of contracting currency. What was wanted now was not funding, but

some kind of check over an unlimited recourse by Government [to Bank credit] for whatever period it may be. In the present circumstances, it can only be achieved through informal consultations and understanding and I do not think ... [the] mere conversion of ad hocs into dated securities will help in any way.

But the Bank wanted funding operations to proceed on a modest scale if only to prevent the precedent which had now been set from falling into disuse. Support from the government too proved less reluctant so long as it did not have to pay a discount, and after Finance Ministry officials were convinced that relatively small-scale funding operations would not greatly erode the Bank's current depreciation provision (which was in any case normally higher than that warranted by the 'approved scale') and that funding operations would mean little or no loss of revenue to the exchequer. Thus the Bank and the government decided to cancel ad hoc bills to the tune of Rs 150 crores in December 1959.

Thereafter the Bank resolved to fund Rs 50 crores of these bills annually until its holdings of them came down to Rs 500 crores. To its credit, the Bank managed in consultation with the government to achieve or exceed its annual funding target every year. But inevitably, thanks to the rate at which the government created these assets in the 1960s, the other goal of bringing the volume of ad hocs in the Bank's books down to Rs 500 crores proved

elusive. Larger and more meaningful funding operations were also moreover no longer within the realm of practical policy by the mid-sixties, the government for instance turning down the suggestion officials at Mint Road made in 1964–65 for a modest increase in the volume of ad hocs funded to Rs 75 crores. With the Bank's executives learning to live with this reality, the funding of ad hocs became another routine event in the institution's calendar. As an office note, written in November 1967 to prepare the ground for the next funding operation, remarked with an irony of which its author may not have been unaware,

in the past it was indicated that we should resort to cancellation of ad hocs for Rs 50 crores annually until the figure [for the total volume of ad hocs outstanding] was reduced to Rs 500 crores, the present balance of which is Rs 1,514 crores .... Having regard to the size of the present holdings of ad hocs it is suggested that we may go in for funding of a further Rs 50 crores as was done on the last occasion.

#### PUBLIC BORROWING: AN OVERVIEW

The public's net absorption of gilt-edged stock during the course of the year offers a good index of the government's success in marketing its loans. During the first plan years, the government's loan programme proved insufficient to satisfy the market's appetite for its securities, and the excess demand was met out of the Bank's holdings of them. In all but one of the remaining years of the period covered by this volume, however, there was an excess supply of gilt-edged securities in relation to demand, and overall during the second and third plan years, net purchases by the public amounted only to about 60 per cent of the increase in the loan liabilities of the central and state governments. (The corresponding proportion for the period as a whole was about 73.5 per cent.) The Bank, the central government, and the state governments accounted for the remainder (table 5). The pattern of ownership of government securities (table 6) as revealed by the surveys the Bank conducted at regular intervals after 1958 also reflects its rising share of the government's debt. Insurance companies' holdings remained largely unchanged in proportional terms, while the importance of commercial banks declined. On the other hand, there was a nearly threefold rise in the share of provident funds' holdings of central and state government loans.

The Bank's monetary policy stance during these years being generally one of restraint, we should expect to find its open-market operations characterized

by net sales of government paper. Besides, the large subscriptions the Bank made to central loans at the time of their issue would have meant, other things remaining the same, that it was more likely to enter the market as a seller than as a buyer. As table 7 shows, the Bank indeed made net sales of government securities during these years. But their extent (net sales represented only about 9 per cent of the Bank's aggregate open-market transactions in gilt-edged stock during these years) might seem unexpectedly small.

The Bank's open-market operations were at best a passive feature of its monetary policy. According to an authoritative note on the objectives of its open-market policy, the Bank's operations in this sphere were intended to promote 'orderly market conditions', effect sales 'on a net basis over the year' of the Bank's security holdings, and 'even out ... distortions in the yield pattern'. Of these, the first objective was by far the most important. In 1960, for example, credit policy was sought to be tightened by impounding a quarter and then half the additional deposits of banks. But the Reserve Bank persisted in feeding them funds through purchases of government securities to the tune of an unprecedented Rs 150 crores. More generally, thanks to the over-supply of government paper especially in the 1960s, the Bank's open-market operations threatened with increasing frequency to undermine its monetary policies rather than support them. Note from table 7, for example, that the Bank was a net buyer of securities to the sizeable tune of nearly Rs 52 crores during 1960-66 when its lending rate went up from 4 to 6 per cent and when it initiated a series of measures to regulate the accommodation extended to banks. However, the new statutory liquidity requirements and the institution of the net liquidity ratio-based lending regime in 1964 helped increase the demand for government paper, particularly among foreign and the larger Indian banks. They also lent a tone of stability (mainly seasonal but also generally) to the gilt-edged market and some teeth to the Bank's monetary policies.

Finally, it was pointed out above that the Bank wished simultaneously to stretch out maturities into the longer term and increase the issue of short-dated stock to attract larger support from banks. The resulting thinning in the middle of the maturity structure of government stock is reflected in table 8. Table 9 captures the growth of ad hoc treasury bills during our period while table 10 summarizes the volume of treasury bills outstanding every year.

**Table 5:** Absorption of Government Securities

Year	Net market borrowings by the centre and states	Net absorption by public	Col. 3 as percentage of Col. 2
1	2	3	4
1951-52	-24.9	-9.6	
1952-53	12.9	33.4	258.9
1953-54	-3.5	80.5	
1954-55	110.7	92.5	83.6
1955-56	82.0	93.1	113.5
Total I Plan	177.2	289.9	163.6
1956-57	140.7	70.6	50.2
1957-58	70.7	113.3	160.3
1958-59	226.8	194.6	85.8
1959-60	174.7	143.1	81.9
1960-61	134.0	-63.7	
Total II Plan	746.9	457.9	61.3
1961-62	136.8	35.6	26.0
1962-63	183.4	99.1	54.0
1963-64	150.0	100.7	67.1
1964-65	185.1	172.8	93.4
1965-66	234.3	137.5	58.6
Total III Plan	889.6	545.7	61.3
1966-67	176.7	169.1	95.7
Total	1,990.4	1,462.6	73.5

- NOTES: (1) All amounts in Rs crores.
- (2) These figures do not include transactions on state governments' cash balance investment account, the Bank's operations in state loans, and repayment of state loans held by state governments.
- (3) The term 'public' includes all investors other than the Reserve Bank and the central and state governments. The total net absorption of government securities by the public equals subscriptions by the public, less cash repayments to the public in respect of maturing loans plus (or minus) net open market sales (or purchases) by the Bank and for the government's cash balance investment account.
- (4) Figures from 1956-57 include investments of P.L.480 funds. These are excluded from 1960-61 because of the change in the arrangements for banking these funds. Hence the two sets of figures are not strictly comparable.

SOURCE: *Reserve Bank of India Bulletin*, March 1968.

**Table 6:** Ownership of Central and State Government Securities

	At the end of	
	December 1957	March 1967
1. Governments	10.9	8.1
2. Reserve Bank of India (a+b)	17.0	31.1
(a) own account	15.6	30.2
(b) on account of others	1.4	0.9
3. Banks	24.0	22.9
4. Insurance companies	13.5	13.8
5. Provident funds	5.5	15.0
6. Others	29.1	9.1
Total	100.0	100.0

NOTES: (1) Figures are percentages to total.

(2) Others include joint-stock companies, local authorities, trusts, individuals, state financial corporations, etc.

SOURCE: *Reserve Bank of India Bulletin*, February 1960 and March 1968.

**Table 7:** Open-market Operations

Year ended March	Purchases	Sales	Net sales or purchases (-)
1951	155.4	98.8	-56.6
1952	66.7	54.7	-12.0
1953	12.9	14.3	1.4
1954	17.8	40.0	22.2
1955	30.1	57.8	27.7
1956	22.1	38.0	15.9
1957	47.5	28.3	-19.2
1958	24.2	89.2	65.0
1959	65.2	154.3	89.1
1960	23.3	83.6	60.3
1961	138.4	26.0	-112.4
1962	66.6	33.0	-33.6
1963	72.3	49.5	-22.8
1964	30.0	74.7	44.7
1965	73.1	147.2	74.1
1966	95.8	93.6	-2.2
1967	65.1	128.0	62.9

NOTE: All amounts in Rs crores.

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

**Table 8:** Maturity Distribution of Central and State Loans

Maturity period	December 1957	March 1967
0-5 years	31	44
5-10 years	37	22
10-15 years	12	11
Over 15 years	7	17
Non-terminables	13	6
Total	100	100

NOTES: Figures are percentages to total.

SOURCE: *Reserve Bank of India Bulletin*, February 1960 and March 1968.

**Table 9:** Growth of Ad hoc Treasury Bills

Period	Ad hocs created	Ad hocs cancelled	Net ad hocs created	Ad hocs funded	Net after funding
I Plan	350	100	250		250
II Plan	1,975	1,030	945	500	445
III Plan	2,430	1,630	800	275	525
1966-67	705	445	260	50	210
Total	5,460	3,205	2,255	825	1,430
Ad hocs created in connection with pensionary and other liabilities					164
Ad hocs outstanding at the end of March 1967					1,594

NOTES: All amounts in Rs crores.

SOURCE: *Reserve Bank of India Bulletin*, March 1968, and statement submitted to the Committee of the Central Board, 12 April 1967.



**Table 10:** Treasury Bills Outstanding

At the end of March	Total	of which ad hocs
1951	358	275
1952	314	268
1953	315	261
1954	335	253
1955	472	366
1956	595	488
1957	836	714
1958	1,295	1,190
1959	1,225	1,022
1960	1,298	1,020
1961	1,106	886
1962	1,175	912
1963	1,300	1,048
1964	1,382	1,099
1965	1,444	1,142
1966	1,612	1,388
1967	1,920	1,594

NOTES: (1) All amounts in Rs crores.

(2) Ad hocs outstanding during 1951–54 were created in 1948–49 to replace sterling securities in the Issue Department transferred to the British Government under the Sterling Balances Agreement of July 1948; ad hocs were created from 1954–55 almost wholly to replenish the centre's cash balances.

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