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Banking for State Governments

Constitutionally and historically, the Bank's relations with state governments evolved rather differently from those with the centre. Section 21 of the Bank Act which defines relations between the Bank and the central government is, as we saw in the last chapter, mandatory in character. But section 21A, which deals with relations between the Bank and state governments, is permissive.[1] In the constitutional set-up emerging out of the Government of India Act, 1919 (sections 45A and 80A), which was in force when the Reserve Bank of India Act was passed and the Bank came into existence, in 1934 and 1935 respectively, local legislatures were not competent to make any laws detracting from section 21 of the RBI Act. With the inauguration of provincial autonomy in 1937 under the Government of India Act, 1935, a province's public debt fell squarely within the competence of its legislature. But the Reserve Bank continued to discharge these responsibilities, since under section 292 of the Government of India Act, 1935, all the laws in force in British India when the former came into effect continued in force until a competent legislature decided otherwise. Although Madras objected to the Reserve Bank being entrusted with the management and issue of its public debt, no province passed laws, as it was competent to do, enabling its debt to be managed or issued differently. It was much less clear whether provincial legislatures had the power to pass laws under section 151 of the Government of India Act, 1935, differing in their provisions from those of section 21(1) of the Bank Act as it existed at

[1] Section 21A was introduced in 1951 by splitting section 21 as it existed prior to the amendment into two sections. The new section, which came into effect in November 1951, now reads as follows: 'The Bank may by agreement with the Government of any state undertake—(a) all its money, remittance, exchange and banking transactions in India, including in particular, the deposit, free of interest, of all its cash balances with the Bank; and (b) the management of the public debt of, and the issue of any new loans by, that State.'

the time, dealing with the custody of a provincial government's funds. In the event, no province contemplated such a legislation, so that the whole of section 21 of the Bank Act continued to remain in force up to the Republic's inauguration in 1950.

Under the Constitution of India (Art. 372), all laws applicable in the territory of India at the time of its commencement were to continue in force until they were repealed or altered by a competent legislature. Thus while section 21 of the Reserve Bank of India Act continued to apply to the so-called Part A states, neither this section nor the wider piece of legislation of which it formed a part applied to the so-called Part B states made up of territories belonging to the former princely states. The extension to the latter of the Reserve Bank's role as banker to government and the reforms attending this step therefore held both symbolic and substantive significance at the time, and were thought to represent an important landmark on the road to India's political-economic integration.

THE BANK AND FEDERAL FINANCIAL INTEGRATION

The problem of integrating in the financial sphere provinces which were coming together in the political acquired urgency soon after the accession of the former princely states. The Indian States Finances Enquiry Committee (V.T. Krishnamachari Committee, 1949) remarked on the unsatisfactory nature of currency and governmental banking facilities in the former Part B states. Recognizing the importance of treasury, currency chest, and remittance arrangements in promoting both the deepening of the financial sector of the economy and the integration of the Union, the committee underlined the need to study them more closely as a prelude to future reform.[2] A review of the treasury and allied arrangements prevailing in the former Part B states was therefore included among the terms of reference of the Rural Banking Enquiry Committee (Purshotamdas Thakurdas Committee, 1950).

The Rural Banking Enquiry Committee found that treasury, currency

[2] 'Treasury' arrangements refer to those made for the receipt and payment of monies on the government's account. 'Currency chests' comprise 'large stocks of notes and coin ... kept in separate receptacles at important treasuries in order to provide currency for the transactions of Central and State Governments'. Currency chests form part of the Issue Department of the Reserve Bank. Payments into the chest by the government constitute payments to the Reserve Bank, and withdrawals constitute receipts from the Bank. In principle, currency chests enable the government to deploy surpluses at one centre to meet deficits at another without physically moving funds from the former to the latter.

chest, and government banking functions in the Part B states were either performed departmentally or by the Imperial Bank of India, and one or more local banking institutions which were mostly ill-equipped to handle larger responsibilities in this sphere. Among the latter were the State Bank of Saurashtra in Saurashtra; the Bank of Mysore in Mysore State; the State Bank of Bikaner, the Bank of Jaipur, and the Bank of Rajasthan in Rajasthan; the Bank of Indore in Madhya Bharat; the Bank of Patiala in the PEPSU (Patiala and East Punjab States Union); and the Hyderabad State Bank in the former Nizam's dominions. The committee strongly advocated converting non-banking (or departmental) treasuries into banking treasuries. Doing so would enable banking facilities to spread to rural areas and bring the public into regular contact with banking institutions, and together with the spread of currency chests, help promote integration by making it easier to remit funds from one centre to another. It recommended bringing banking and treasury arrangements in these states in line with those prevailing in the provinces. In operational terms, this meant appointing the Reserve Bank of India as the sole banker to the governments of the Part B states. In the committee's view, this was fundamental to the whole scheme of federal financial integration and a necessary precondition for ensuring uniformity in banking, treasury, and currency chest arrangements across the length and breadth of the country. Other banks, including those currently performing governmental functions in these states, the committee recommended, could continue to do so as agents of the Bank provided the latter found them equipped for the role.

Alongside these investigations, the government also took steps to amend the Reserve Bank of India Act to enable it to become the banker to Part B states after executing agreements with them. The amendment was necessitated because legal opinion at the time held that Parliament was not competent to extend the scope of the existing section 21(1) and (2) of the Bank Act to Part B states since, as pointed out above, the custody of the consolidated and contingency funds of a state and its public debt were subjects solely within the competence of its legislature. The Bank's original (and, as we will observe below, enduring) inclination was to make the resulting amendment to section 21 mandatory, on the 'pith and substance' assumption that since the 'Reserve Bank of India' formed part of the Union list, the whole of an Act amending the Bank Act fell within the legislative competence of Parliament even though the amending Act might 'incidentally encroach' upon the 'custody of state monies' and the 'public debt of a state'. But with the Law Ministry opining that the pith and substance principle would not suffice to make the amendment *intra vires*, the Bank and the government were faced with the option of either taking recourse to Art. 252 under which sections 20 and 21 of the Bank Act could be extended to Part B states after their legislatures passed resolutions to that effect, or making the amendments to section 21 in a permissive form. The Select Committee on the amendment bill preferred the latter course. Arguments in its favour were strengthened by the Bank too now adopting the temporizing view that it would not be possible for it immediately to 'undertake in any Part B state all the functions ... at the same time', and that it would be better to word the new legislative provision in a manner as to allow it some choice in the matter.

Even as this amendment bill inched its way through the legislative maze, the Bank began to canvass governments of the Part B states about the recommendations of the Rural Banking Enquiry Committee. These governments were generally not unreceptive to the recommendations and almost all of them were willing in principle to appoint the Bank as their bankers. But differences cropped up between the Bank and some state governments over the role that banks in which they held a considerable interest and which currently transacted treasury and banking functions on their behalf would have in the new dispensation. Understandably, some state governments were also not keen to lose the accommodation facilities they enjoyed from their current bankers and the interest they earned on the cash balances they maintained with these institutions. Although the Bank denied any intention to 'hustle ... States' into the new arrangements, it was nothing if not persistent. The Reserve Bank's eagerness to achieve the financial integration of the Part B states may partly be explained by the intrinsic merits of the scheme and the importance it attached to the role of banker to governments. As a confidential brochure on the integration proposals which the Bank prepared for use by state governments pointed out, central banks all over the world functioned as 'bankers to Government and [held] their accounts'. Apart from being 'economical and convenient', this arrangement was necessary because of the

> intimate connection between public finance and monetary affairs and the opportunity it affords to the Central Bank of assessing the financial situation at any given time and of giving appropriate advice to Government and taking necessary remedial measures.

The Bank's seeming persistence also owed in some measure to the newly unleashed energies of the Department of Banking Development which had recently been created to give effect to the recommendations of the Rural Banking Enquiry Committee. Thus without waiting for the Reserve Bank of India (Amendment) Act, 1951 to be passed, N.D. Nangia, the acting head of this department, began pressing the central government to take 'preliminary steps' to ensure that the agreements with the Part B states envisaged in the Act were signed without delay. He urged the central government in April 1951:

> While there may be some room for difference of opinion as to whether or not the Imperial Bank should be appointed the Reserve Bank's agents in all the Part 'B' States, the Government of India will, no doubt, agree that the matter of the appointment of the Reserve Bank as bankers to all States is of such fundamental importance that, if necessary, they should not hesitate to exercise their powers under the Constitution to overcome any difficulties that may be raised by the States.

The Government of India followed the Bank's suggestion and at the end of June 1951, advised governments of the Part B states to take the steps needed to appoint the Bank as their bankers by April the following year. The target date was subsequently put off to July. But the government was also more sensitive than the Bank to the special situation prevailing in some of the Part B states and the susceptibilities of their governments. There was, according to a view that the Bank gathered both from the central government and through its direct contacts with officials of the Part B states, a general 'impression amongst the representatives of several governments' that an agreement with the Reserve Bank would lead to their 'autonomy in financial matters ... [being] seriously encroached upon ....' Two issues, in particular, seemed to call for attention. The first as noted above was the role in the new arrangements of the state-associated banks which carried out treasury and banking functions on behalf of some Part B states. The central government took the line that where a state had 'developed a Bank of its own and ... entrusted it with ... treasury functions' it was 'retrograde now to ask them to reverse the process and themselves assume treasury functions'. Much better to entrust treasury work to them as agents of the Reserve Bank under 'suitable safeguards'.

Following the central government's advice, the Bank began to take a more pragmatic and differentiated view of agency arrangements in the Part B states. Subject to certain conditions relating to its powers of inspection over them, the types of business they could undertake, the appointment of their chief executives, and the presence on their boards of a nominee each of the Bank and the central government, the Bank now grew ready to entrust agencies to some of the former state-associated banks. These included the State Bank of Saurashtra and the Hyderabad State Bank for Saurashtra and Hyderabad respectively, and after a 'suitable interval', the Bank of Mysore for the former

Mysore state. The Bank was also willing to offer agency in Rajasthan to a bank, if one could be formed expeditiously, that amalgamated the operations of the Banks of Rajasthan, Jaipur, and Bikaner. The Travancore and Patiala banks, however, were not to be entrusted agency arrangements for another three years, while the Bank of Indore was judged unlikely in the near future to qualify for agency responsibilities.

The second issue pertained to short-term accommodation to governments of the Part B states many of whom had arrangements with the Imperial Bank and other commercial banks to draw ways and means advances. 'Theoretically', such arrangements, the central government agreed, were 'inconsistent with the relationship envisaged for the future between the State and the Reserve Bank'. But

> our experience with the smaller Part A states is that it is not always possible for them to meet the short fall in the ways and means by short-term borrowing in the market and the restriction of ways and means accommodation by the Bank to the amount of the minimum balance has operated too harshly on them.[3]

While states should be asked to terminate their arrangements with the Imperial and other banks, the government felt, the Bank 'ought to evolve a more flexible arrangement for the grant of accommodation by the Reserve Bank ....' Officials at the Finance Ministry and the States Ministry advised:

> If the Reserve Bank's accommodation is to be strictly limited to three months loans not exceeding the minimum balance of the state, this is bound to raise a difficult situation for many states. Until they establish their credit some kind of transitional arrangement enabling them to continue their present borrowing facilities would seem inescapable.

The Bank's keenness to speed up the country's financial integration wavered briefly towards the end of 1951 and in the early months of 1952 when it began apprehending that rapidly expanding currency chest facilities would encourage state governments to draw upon them to finance their deficits. The circumstances in which the Bank came to harbour this apprehension and the manner in which it sought unsuccessfully to tackle this problem are discussed at greater length below. Suffice it to note here that at the same time as the Bank was momentarily balking at the prospect of having perhaps to forsake a certain degree of monetary control to secure better financial integration, the

[3] Ways and means and minimum balance provisions for states are discussed below.

governments of some of the Part B states grew more attracted than before to the idea of coming under the 'scope of the Reserve Bank of India Act'.

The developments that made for this change of attitude included the revival of the market for state loans and the crucial role the Bank played in managing the loan issues of state governments, particularly after the practice of underwriting state loans was abandoned in 1951. States' requirements for loan finance went up sharply with the inception of planning and the proliferation thereafter of loan-financed development projects. Although nothing prevented a Part B state which had not appointed the Bank as its banker from floating loans in the market, it could not count on the Bank's assistance in managing the issue except in the event of the Public Debt Act, 1944 being extended to its future loans after its legislature passed resolutions to that effect under Art. 252(1) of the Constitution. Until then, it could expect to 'pay higher interest rates than would otherwise be necessary'. Though the Art. 252(1) procedure was being talked about, it appeared to several governments to be an elaborate and time-consuming process. At the same time, the attractions to the Part B state governments of their existing banking arrangements seemed to pale before the promising prospects of an agreement with the Reserve Bank, particularly if the latter would extend substantial accommodation to them, and the banks in which they held an interest could be appointed as agents of their new banker. Thus in very short order, the governments of Madhya Bharat, Travancore-Cochin, Mysore, and Hyderabad appointed the Bank as their banker during the course of 1952 and 1953.

Two states—PEPSU and Rajasthan—however held out. In both cases, the bone of contention related to the nomination of the agency bank. For reasons discussed elsewhere, the Bank was unwilling to contemplate the Bank of Patiala as an agency bank, while mutual rivalries and bickering kept the three Rajasthan banks from coming together to realize their combined potential to be the Bank's agents in the state.

Against the background of the failure to reach agreements with the governments of PEPSU and Rajasthan, the constitutional and statutory provisions governing relations between the Bank and state governments came once more into focus after the All-India Rural Credit Survey submitted its report. This report recommended amending the law and 'if necessary ... the Constitution' to

> make it obligatory on all State Governments and not merely, as hitherto, the State Governments of Part A and Part C states, to appoint the Reserve Bank as their sole banker.

Legal opinion also held that Art. 283(2) of the Constitution would have to be amended if the 'custody of moneys of *all Governments* should be compulsorily entrusted to the Reserve Bank' [emphasis in original]. As things stood, the Bank's Legal Adviser, B.N. Mehta, argued, even the legislature of a Part A state 'can now make a law taking the custody of the moneys of the State out of the hands of the Reserve Bank'. Following these ruminations, Rama Rau addressed the Finance Ministry in December 1954 asking it to take the opportunity presented by the recent introduction in Parliament of a bill to amend the Constitution to effect the necessary changes to the text of Art. 283(2). The Bank, the Governor informed the Finance Ministry, 'had arrangements with all the Part B States', but it was encountering 'difficulties in regard to PEPSU and Rajasthan'. Since it was 'difficult to amend the Constitution frequently', the present opportunity should be used, he argued, to pass an amendment which was 'not at all likely to be controversial, for it [only] places all Part B States in the same position as Part A and Part C States'.[4]

The Finance Ministry conceded the strength of the Bank's general point that it was 'desirable from a long-term point of view to ensure uniformity ... and to obviate the possibility of future retraction by any State' of its appointment of the Bank as its banker. But for procedural reasons, this amendment could not be joined to the existing bill and had therefore to be deferred. On the other hand, the Finance Ministry told the Bank in February 1955, 'with the State Bank of India in the offing', the chances of these two Part B states falling in line had 'greatly improved'. The public debt of Rajasthan and PEPSU too, would be entrusted to the Bank once their legislatures passed resolutions under Art. 252(1) submitting the state to the provisions of the Public Debt Act. As for the other aspects of its relations with these state governments, the central government advised the Bank, it was 'preferable ... for obvious reasons ... to reach ... agreement by voluntary negotiation'. In the event, the lack of uniformity in the application of the Bank Act to the different categories of states within the Union, which was a source of concern to the Bank, ceased to be of any consequence before long, since the reorganization of states in 1956 put all the states of the Union on the same footing. But the clause in the Bank Act defining its relations with state governments has continued to be permissive in character and different in wording from that defining its relations with the central government.

[4] The Part C states were Ajmer, Bhopal, Bilaspur, Coorg, Delhi, Himachal Pradesh, Kutch, Manipur, Tripura, and Vindhya Pradesh.

WAYS AND MEANS ADVANCES AND STATE GOVERNMENTS' OVERDRAFTS

Under section 17(5) of the Reserve Bank of India Act, the Bank is allowed to make ways and means advances to the central and state governments repayable in three months. As we saw in the last chapter, the Bank's accommodation to the central government was extended against ad hoc treasury bills. In contrast, accommodation to state governments took the form of unsecured and secured ways and means advances. Although the legal view was that nothing in the law prevented the Bank from renewing the accommodation it extended to a state government, it preferred generally not to allow such renewals to take place. While this policy worked well until 1948, thereafter several instances arose of state governments being unable to repay their advances even after they were called upon to do so by the Bank.

Unlike in the case of the central government, ways and means advances to state governments were subject to certain limits set usually at a multiple of the minimum balances they were obliged to maintain with the Bank. Although initially ways and means advances to state governments were also referred to as overdrafts, in course of time the latter term was used to refer to drawals by state governments in excess of their ways and means limits.

In 1937, when the Bank first entered into agreements with provincial governments, minimum balances varied between Rs 5 lakhs for Orissa and the Northwest Frontier Provinces and Sind, to Rs 40 lakhs for Madras, and aggregated to Rs 1.90 crores. Provincial governments were also allowed to draw ways and means advances to the extent of their minimum balances. After the partition of the subcontinent, aggregate balances and limits declined to Rs 1.52 crores, but rose thereafter as the Part B states were brought within the ambit of these arrangements. Although borrowing from the Bank in excess of these limits was not unknown, the latter generally sufficed to meet the temporary financial needs of provincial governments until the early fifties. But they proved inadequate for the needs of governments disposed now to play a more active developmental role, and from October 1950 some states began running up large overdrafts on their accounts with the Bank. The most prominent among these was the Madras government, whose account was almost continually overdrawn from April 1951 to July 1953 and whose overdrafts on one occasion exceeded Rs 22 crores against the normal ways and means limit of Rs 40 lakhs.

The stock explanation the Madras government gave for its 'chronic indebtedness' to the Reserve Bank was that the overdrafts arose because of the 'large expenditure ... on development and irrigation projects ... approved by the Planning Commission'. The state government also argued that these schemes had reached an 'advanced stage' at which they could not be slowed down or abandoned. In addition, officials from the state argued, the government had to meet large expenditures on famine relief and stocking up foodgrains. Bihar and Orissa were the other states which ran up overdrafts during 1950–53.

As the Bank was aware from the outset, it could do little under the existing arrangements to check overdrafts of governments since individual agents had no information about the current credit of the state government. The latter's net cash position was worked out each working day by the Bank's Central Accounts Section in Calcutta and these calculations were inevitably subject to different reporting lags. Even after it was established that a state government was in the red, the decision to dishonour its cheques had to come from the centre. As a Bank memorandum pointed out,

> there is no provision in the Reserve Bank of India Act for allowing such overdrafts but we have no alternative than to acquiesce in them. Under the present procedure, state governments can draw upon us, the State Bank of India branches, treasuries, etc. *without any limit* and we or our agents cannot dishonour cheques drawn by the state governments [emphasis in original].

Disturbed by the prospect of state governments making unregulated drawings from currency chests and treasuries to finance their budget deficits, the implications of such drawings for monetary stability, and the helpless state to which it was reduced in dealing with the problem, the Bank even turned its thoughts in the latter part of 1951 and in the first few weeks of 1952 to devising 'drastic changes ... in the treasury and accounting set up of the country ....' The changes officials at the Bank turned over in their minds extended to 'curtailing' currency chest facilities—it was initially thought that overdrafts by state governments largely took the form of 'raiding currency chests', i.e. making drawals from them in excess of the payments made into them—or setting up an independent machinery to handle the central government's transactions with the public and leaving state governments to their own banking devices. Nothing much came of these ruminations. While the former course was not seriously pursued for fear that it would lead to 'considerable ... dislocation, the country having become used to the system over ... 70 years', force state governments to hold their balances outside the banking system, and reduce remittance facilities, the latter was thought to be both inexpedient and 'highly expensive'. Until 'some safeguards ... [were] devised ... to ensure that currency chests would not be operated upon to support budgetary deficits', the Bank and the government agreed towards the end of 1951, 'it would be better to confine the chests to a few principal centres, and to see that the balances therein were kept as low as possible'. But this policy was never seriously followed because it was soon realized that the expression 'raiding currency chests' was merely a metaphor for state governments' overdrafts and not an accurate description of the banking and other arrangements which gave rise to them. Although 'raids on currency chests' were not altogether unknown and Madras was known to have been particularly successful at them in 1950–51, contrary to the earlier impression states' overdrafts resulted mainly from payments made at the offices of the Reserve Bank and its agent(s). Restricting the expansion of currency chest and treasury facilities, it was therefore felt, was no answer to the problem.

There cannot be much doubt that at least momentarily, until B. Venkatappiah (who came to Mint Road as Executive Director in October 1950) brought his steadying influence and his experience of financial administration in the Bombay state to bear on its thinking on this subject, the Bank's executives were shaken by their experience in dealing with state governments' overdrafts. Both Ram Nath and Sundaresan, the two Deputy Governors, were orthodox central bankers. Rama Rau was no less orthodox at this time for having been a civil servant, and it is not unlikely that their collective hopes for financial integration were gravely weakened by the conflict they saw between this imperative and the Bank's statutory mandate for preserving monetary stability. The Bank used a variety of means, ranging from formal approaches to informal links with officials of state governments, to urge the latter to 'keep a vigilant eye on their ways and means position'. The Bank also produced, in due course, a formidable body of work on the finances of state governments. Initiated partly as an outcome of B.K. Madan's membership of the first Finance Commission, this work continued as a result of the close interest the Bank took in the financial problems of state governments, and gave it unmatched expertise on this subject.

Useful as such knowledge was, the problem of states' overdrafts and the conflict between monetary stability and deeper financial integration had, in the ultimate analysis, both to be addressed in the political domain. Besides, with the Bank as well as the central government formally committed to integration, it became necessary to devise other solutions to overcome the problem.

The state governments sought more generous ways and means limits. In this they had the support of the central government. For its part, the Bank sought an increase in the minimum balances state governments were required to hold, on the ground that the 'cost of management and the turnover on government accounts' had risen substantially since these balances were fixed

The inaugural meeting of the first Finance Commission, New Delhi, December 1951. B.K. Madan is at the extreme right. At the other end is M.V. Rangachari, later Deputy Governor.

in 1937, the revenues and expenditures of the provincial and central governments, both taken together and separately, having for instance quadrupled between 1937–38 and 1950–51. On the other hand, interest rates had come down, and with them the compensation to the Bank for discharging its duties as banker to governments. As a result, the income the Bank earned annually from its investment of the minimum balances of the central and state governments amounted only to Rs 6.57 lakhs, but the agency commission it paid to the Imperial Bank alone amounted to more than four times that figure.

The Bank's solution, which it advanced during the course of 1952, was to quadruple the aggregate minimum balances of state governments. The central government preferred a doubling of these balances to avoid straining states' resources. The Bank's proposal to quadruple the existing limits for ways and means advances to state governments was, however, retained so that they were now set at twice the revised minimum balances. In addition to 'normal' ways and means advances, each state was now allowed to draw a special advance of up to Rs 2 crores against central government securities. The interest rate on the former remained at one per cent below the prevailing Bank rate, while that on the latter and overdrafts varied with the size of the drawings. Several states wanted more generous limits and lower rates of interest, but Madras—whose budget was said to have been in deficit for nine months of the year—demanded limits that were adequate to cover its budgetary gap. The real consideration shaping the Bank's policy, the Madras government argued, should be 'whether the needs of the state government are genuine and whether the Bank has the necessary funds'. In addition, Madras sought additional advances to be made against the general security of state governments' revenues and assets.

There was little sympathy at Mint Road for the Madras proposals which, if accepted, would tempt even the most prudent state government down the path of fiscal profligacy. The Bank, Ram Nath told the central government, could not contemplate undertaking a financial liability of the kind proposed by the Madras government and if states wished to persist with deficits, some other machinery would have to be devised to finance them. States, he pointed out, wanted to be autonomous financially, but refused to pay their own way. As a result, the 'scheme for financial autonomy' had come to mean, for both the Bank and the government,

> the worst of both the worlds, with the States pursuing their own courses under the guise of financial autonomy and at the same time requiring the Centre to put up the resources needed (directly or through Reserve Bank) for meeting the inevitable financial consequences of those policies.

The revised limits came into operation from April 1953 for all states except Madras which, along with the newly formed state of Andhra, exchanged the necessary letters in August 1954. These limits and minimum balance requirements were adjusted in 1956 at the time of the reorganization of states but no fundamental revisions were made to them until 1967.

The new limits failed in their intended object of averting overdrafts by state governments. Andhra, which was carved out of the former Madras state, followed in the latter's footsteps and soon ran up sizeable overdrafts, while Orissa and Bihar became persistent offenders. At the Bank's instance the Finance Minister, C.D. Deshmukh, apprised the Union Cabinet of the problem in January 1956. Overdrawing by states, a memorandum prepared for the cabinet pointed out, not only 'contravened' agreements between their governments and the Reserve Bank, they also forced the latter to

> act against the provisions of the Reserve Bank Act which prohibits advances of more than three months' duration. They also contravene[d] Article 293(2) of the Constitution which requires prior sanction of the Central Government to State borrowings.

Besides being 'highly irregular', unlimited withdrawals from the currency chests were a potential source of 'extreme danger', for should this 'tendency ... become widespread', it would spell 'an end to financial planning and monetary control'. The Bank had so far chosen not to embarrass offending governments by refusing payments, but the time had now come to put the matter on a 'proper footing'. State governments, the cabinet summary suggested, should 'devise measures' to clear overdrafts immediately after they were brought to their notice, if necessary by borrowing from the centre to cover seasonal shortfalls in revenue collections or delays in receiving plan funds. If however, a state

> is not able to satisfy the Centre that the deficit is due to either of these causes, it must curtail its expenditure forthwith and square up its balance within a fortnight or so, failing which it must face the risk of the Reserve Bank stopping its payments.

Although this was 'an extreme step ... involv[ing] grave issues ... it was ... in the last resort, the only deterrent' which would 'instil a sense of financial restraint and responsibility on the part of the State Governments', the memorandum argued.

The cabinet approved these proposals in general but decided to allow erring states a month's time to bring their accounts back into credit. But the cabinet decision had little impact. Andhra Pradesh, Bihar, and Orissa continued to be in the red where they were soon joined by Kerala and Madhya Pradesh. In July 1957 Bank officials informally canvassed their counterparts in the Finance Ministry about the possibility of implementing the cabinet decision and stopping payments of state governments with persistently overdrawn accounts, but were told that while the centre 'accepted the principle that states should not take forced loans' from the Bank, 'political considerations' prevented it from taking the proposed step. Some weeks later in September 1957 the Governor, H.V.R. Iengar, raised the subject at an informal meeting of the members of the central cabinet and in November at a conference of states' finance ministers. Although the Prime Minister, the Home Minister, and the Finance Minister 'impressed on ... State Gov[ernmen]ts the imperative need' to avoid overdrafts and the state ministers 'nodded agreement', the situation showed no signs of improvement.

In the meantime, the Bank also grew concerned about the manner in which to show states' overdrafts in its books. Its auditors had served a warning in August 1957 that showing overdrafts as 'loans and advances to Governments' was merely a temporary expedient justified only by the Bank's assurance that these debits were 'temporary and would soon be adjusted'. With the latter denouement appearing to recede into the future, the Bank felt the time had come 'to take more drastic steps than hitherto', including the 'politically unpalatable' step of stopping payments from the accounts of overdrawn governments. But the immediate pressure for such measures eased with the Finance Ministry resolving to 'clear the matter up satisfactorily before the end of the current financial year' by releasing to states the grants and loans due to them, and make 'reasonable arrangements for the future'.

The central government intervened as promised to ensure that no state was overdrawn at the end of March 1958. But overdrafts resumed almost immediately in the new financial year and these were once again brought down with help from the centre, so that no state was in the red to the Bank when it closed its books for the year at the end of June. This, in the event, set the pattern for the next few years. More than once, the Bank was disposed to consider measures such as charging states 'really penal rates' on their overdrafts, but was persuaded by the Finance Ministry to abandon them. Penal rates, the latter argued, would only add to the financial burden of states which already faced several demands on their resources but had few means to raise capital or finance deficits. The Bank revived the proposal for 'deterrent rates' in July 1959 when it felt overdrafts were to some extent caused by state governments managing their finances badly. But once again little came of its efforts.

The problem of states' overdrafts abated somewhat over the next two years. But it revived from 1961–62 and for the next few years overdrawn accounts were squared annually, usually with the centre's help, in time for the closing of the Bank's accounts. The centre debited the accommodation from its assistance to the states either the same year or over a longer period, and in some cases special loans were given to states to clear their overdrafts. States felt encouraged by this automatic procedure to increase their excess drawings and this, as we observe below, was soon to become a source of some concern. In the meantime, M.V. Rangachari's arrival at the Bank as Deputy Governor introduced briefly a new dimension to its consideration of the problem. Rangachari had earlier handled states' finances as Special Secretary in the Finance Ministry, and he took the view in a memorandum he presented to the Committee of the Central Board in June 1961, that it was neither

> practicable nor necessary for the Reserve Bank to take action in regard to ... State overdrafts beyond bringing them to the notice of the Finance Ministry and urging them to take remedial action to ... improve the situation. ... the Reserve Bank is not in a position to prevent these overdrafts and it cannot stop payments without paralysing the administration.... There is no danger from the Reserve Bank's point of view, of any loss resulting from these overdrafts as it is inconceivable that the Central Government would remain unconcerned if a State finally defaults. In actual practice they have been clearing these overdrafts from time to time and there is no reason to suppose that they will not continue to do so.

Provoked by Rangachari's observations, Mehr Chand Mahajan, retired Chief Justice of the Supreme Court and a Director on the Central Board, remarked that they were 'in the nature of special pleading in defence of an unauthorized action'. The Deputy Governor, according to Mahajan, merely raised a 'bogie or a ghost' by suggesting that dishonouring a state government's cheques could lead to a political crisis. He questioned the constitutional and legal propriety of the Bank allowing state governments to overdraw their accounts with it, and declared that Rangachari's note would not 'stand scrutiny by the Court'.

The Legal Department of the Bank felt overdrafts were legally in order. Rangachari believed the problem was political and financial, and not one at which merely the law could be thrown. If the Centre was not willing to 'sort out the problem' and a state government defaulted on its obligations to the Reserve Bank, Article 360 of the Constitution (containing 'provisions as to financial emergency') would come into play and 'bring the Centre back into the picture'. Therefore, there was no alternative to the centre—whose financial position was only a little better and which took recourse automatically to ad hoc treasury bills whenever it needed funds—and the states coming to an agreement. The doubts raised by Mahajan were then referred to the Law Ministry. Though informal consultations suggested that the latter sided with Mahajan's view of the matter, the legal and constitutional doubts surrounding it were not conclusively resolved.

The central government's attitude towards states' overdrafts began to harden after the 1962 elections, with both the Finance Minister, Morarji Desai, and the new Governor, P.C. Bhattacharyya, taking a close interest in the problem. Apart from writing repeatedly to chief ministers on the subject, sometimes conveying threats of their payments being stopped, Desai informed Prime Minister Jawaharlal Nehru of the diversion of plan resources which resulted from states' overdrafts and the central government's manner of covering them. Though Desai informed chief ministers that he had authorized the Bank to stop payments where overdrafts were not cleared after the agreed notice period of one month, Bhattacharyya remained diffident at this time about taking so drastic a step. Writing to L.K. Jha, Secretary in the Finance Ministry, at the end of July 1962, he repeated Rangachari's argument that the centre could not wash its hands of the problem, since if a state's payments were stopped, Delhi might have to take over its financial administration. However, departing somewhat from Rangachari's earlier emphasis, Bhattacharyya wondered whether the centre should not invoke Article 360 *before* payments were 'actually stopped by the Bank and ... chaos ... [was] created' in the state. In any case since the issue was ultimately a political one, he sought to know whether the Finance Minister fully appreciated the implications of the Reserve

Bank carrying out his threat to the states. Desai, it appears, was not unmindful of the difficulties state governments would face, but he expected them to approach the centre in such a contingency. The Finance Minister, Jha informed the Governor, wanted to underline the importance of making state governments 'realize that overdrafts from the Reserve Bank are not to be used for meeting ... ways and means difficulties'.

Probably because he felt the Bank balked at taking any extreme measures, Desai took the initiative in January 1963 to draw Bhattacharyya's attention to Bihar's finances. The state's overdrafts continued to be large despite special assistance from the centre. Further assistance, he argued, would merely encourage the state to put off the needed reform of its finances, and the time had come for the Bank to notify Patna of its intention to stop payments of the Bihar government's cheques after a month. When this notice was issued, Bihar informed the Bank that the centre's project assistance was in arrears and that it required two months to set its finances in order. The latter was done with the help of an advance of Rs 7 crores from the centre made on the condition that Bihar would 'accept stoppage of payment by the Reserve Bank as a necessary and inevitable consequence' if it continued to overdraw its account with the Bank. A similar situation was reached with Kerala six months later. Both the centre and the Reserve Bank agreed on the need to dispel the impression states carried that the centre would always step in in June every year to clear their overdrafts. While there was no question of leaving them 'unadjusted' in the Bank's books, states had to be kept under 'continuous pressure' to pay off their excess dues to the central bank.

These resolutions notwithstanding, overdrafts grew considerably in magnitude in the mid-sixties, with the centre having to lend Rs 23 crores to four states in June 1964 and twice that amount to seven states the following year before the Bank's books were closed. As their revenue receipts suffered in the wake of droughts and relief expenditures went up, some governments even began using overdrafts 'in effect as Plan resources'. By October 1965 the problem had become 'chronic' in Andhra Pradesh, Assam, Kerala, and Rajasthan, while state governments in general attached 'little importance to the proper management of their financial affairs'. The central government too grew concerned now about the effect of states' deficits on its own fisk. However, despite Prime Minister Lal Bahadur Shastri and Finance Minister T.T. Krishnamachari repeatedly urging state governments to reform their finances, the situation continued to worsen. Thus by March 1966, ten states had overdrafts aggregating Rs 171 crores.

By 1965 states' overdrafts were complicating the centre's efforts to achieve a measure of fiscal stabilization, and in February that year Bhattacharyya explicitly cited the 'absence of greater fiscal discipline' on the part of state governments as a factor which precluded the Indian government from approaching the International Monetary Fund for the medium-term balance of payments assistance it urgently required. During these months, at the Governor's instance, the Reserve Bank considered terminating banking agreements with states having persistently overdrawn accounts. But by the end of the year, it had veered round to Rangachari's view that this was not a 'desirable' course to adopt, since it would

> throw the States in the hands of commercial banks and they might get into overdraft arrangements with such banks which might affect the security of the depositors. There is also the danger that periodically the State administrations might be brought to a standstill ... when funds from the commercial banks cease to be available.

The more 'practicable' solution, according to Rangachari, was to ensure that states did not have 'free or unlimited access' to currency chests located at non-bank treasuries and to the facilities available at banking treasuries. The principal proposal in the latter regard to emerge from discussions between officials of the Bank, the Finance Ministry, and the Comptroller & Auditor General's office was that of regulating expenditures from currency chests 'through a system of monthly or quarterly letters of credit or limits on drawings .... placed on all drawing and disbursing officers'. These limits were to be related to budget estimates of state governments determined in consultation with the Bank. Such a 'radical scheme', its sponsors felt, could be 'sold' to the states only as a measure to 'reform and modernize ... the existing archaic treasury system', and if the opportunity was taken to regulate the central government's ways and means as well.

> After all, there is not much difference between the States running an overdraft with the Reserve Bank and the Centre financing its deficit by the automatic issue of ad hocs when the balance falls below a limit which is the present practice. This is well known to the States and some of them have in the past suggested that they should have the same facilities. It is therefore essential that the changes in the procedure which are proposed are put as common to both the States and the Centre.

Although Bhattacharyya himself was attracted to the idea of states being persuaded to consult the Bank about their budget estimates, officials at the Bank did not find much to commend in the new system of checks. Apart from its feasibility being in doubt—there was no reason to expect state governments to abide by a system which gave the Bank's officers the power to question the provisions of their appropriation acts—some officials at the Bank feared it would result in 'continuous bickering between the States and the Reserve Bank' and perhaps culminate in the former having 'access to deficit financing from Reserve Bank ... in exactly the same way as the Centre'. 'In fact', according to the Bank's Secretary, S.D. Deshmukh, it was 'better to concede this [right at the beginning] than to accept the present proposal'. The system of regulating drawals by disbursing officers had had Rangachari's blessings, but B.N. Adarkar, who replaced him as Deputy Governor, proposed a simpler solution in April 1966, whereby the central government took over the overdrafts of states as and when they occurred instead of waiting until June each year, converting them into advances to their governments, and recovering the latter from the assistance due to them.

Adarkar's proposal attracted wide support within the Bank and a modified version of it was eventually put forward in August 1966 as part of a plan to increase states' ways and means limits. But the scheme the Bank finally chose to convey to the Government of India in May 1966 was a modified version of the one proposed by Rangachari who, despite having meanwhile joined the Mysore government, continued to assist the Reserve Bank in dealing with state governments' finances. Under this rather elaborate scheme, the Bank was not to be involved in formulating states' budgets or clearing their estimates. The focus, instead, was on controlling the 'flow of expenditure out of the Consolidated Fund so that this by itself does not lead to overdrafts'. Budgeted expenditures adjusted for any deficit in the estimates were to be distributed among the 'various drawing officers' who would make disbursements within their limits and according to budgetary provisions. The Bank had the responsibility for coordinating this system. The Central Accounts Office would convey to each state government daily by telegram, its cash balance position, while officers of the Bank at each state capital would work 'in close association' with the local Finance Department. Enclosing the details of Rangachari's scheme to the Finance Minister, Sachindra Chaudhuri, Bhattacharyya expressed the hope that state governments would

> agree to submit themselves to the suggested small measure of discipline, as the alternative would be for the Reserve Bank of India to request the Central Government to be relieved of the responsibility of acting as the banker to the State Governments ....

The central government circulated the Bank's scheme, along with the sweetener of higher accommodation limits, to the states at the beginning of

June 1966 'in the hope that it could be worked ... [and] more drastic alternatives may not become necessary'. The scheme received a uniformly cold reception from state governments which thought it too cumbersome and impractical. Much to Bhattacharyya's disappointment, the Finance Ministry too, chose not to press the scheme on the states. It preferred, in his words, to 'proceed on the old lines and tell C[hief] M[inister]s that once the normal ways and means limits are refixed any overdraft in excess of such limits will automatically result in stoppage of payment'.

Bhattacharyya was sceptical about the success of this approach. A cabinet memorandum dating from the middle of July 1966 embodying the Finance Ministry's proposals to check overdrafts envisaged requiring state governments to balance budgets and undertake not to run further overdrafts, and subject to these, offering them an increase in ways and means limits. Should a state run into the red after these reforms, the cabinet memorandum proposed, the Bank should ask the overdraft to be cleared within two weeks failing which it could take steps to stop its payments. Bhattacharyya sought stiffer proposals involving more automatic stoppage of payments by states running overdrafts and a commitment from the central government that it would not ask the Bank to 'hold its hand' where states deviated from these terms. But he failed to have his way.

The Bank and the government next turned their attention towards revising the minimum balances and ways and means limits of state governments. There was some discussion about the criteria on which these should be based. The Economic Department proposed relating limits to some proportion (7 to 8 per cent) of the average revenue receipts or capital and revenue receipts of a state in the preceding quinquennium. The suggestion of fixing each state's limits on the basis of the ratio of its past average indebtedness to revenue and capital receipts was also briefly considered. While one Deputy Governor, D.G. Karve, favoured the 8 per cent formula, Adarkar thought the resulting thirteen-fold increase in ways and means limits (on the basis of revenue receipts alone) to Rs 122.75 crores was overgenerous. Besides, he argued, it was better on practical grounds to relate the new limits to old or existing ones rather than use altogether new criteria. His own suggestion was to scale up limits in the same proportion as the increase in the revenue and capital receipts of state governments since 1951, i.e. by a factor of 5.85.

The simplest proposal, and one which the Bank chose in the end to put forward, was to increase the aggregate of states' minimum balances from the level which prevailed in 1937 to the same extent as the central government's minimum balances with the Bank. The latter had increased from Rs 10 crores in 1937 to Rs 50 crores currently and the Bank proposed, after making adjustments for the reorganization of states, to increase their aggregate minimum balances to Rs 12.70 crores. The revision was to be implemented in two stages, with only half the increase coming into effect from November 1966. The Bank also proposed fixing limits for normal ways and means advances at the same level as minimum balances and those for special ways and means advances at double that level. Interest on all ways and means advances was to be charged at Bank rate uniformly. The opportunity of this 'comprehensive review' of its arrangements with state governments, the Bank also argued, should be used to 'enforce the stricter and more logical view' that all ways and means advances to states should be cleared before three months and not allowed to be renewed. The central government, the Bank now proposed in an adaptation of a suggestion Adarkar had made a few months earlier, should take over states' overdrafts whenever the latter failed to clear them within the stipulated period of three months rather than waiting until the end of June to do so. Where a state failed to repay within three months an overdraft secured on the pledge of central government securities, the Bank proposed, the latter should have the power to take these assets over.

The central government responded to these proposals as it had done in the course of similar exercises in the past, by suggesting almost a halving of the revised minimum balances, fixing normal ways and means advances at thrice these balances, and special ways and means advances at twice the normal ways and means limit. The latter limit, the government desired, should not be enforced if the borrowing state government could offer central government securities as collateral. It also proposed lowering the interest charged on all advances to one per cent below the Bank rate. If an unauthorized overdraft persisted for more than a week, the central government proposed, the Bank should ask the concerned state government to clear it within three weeks or face a stoppage of its payments.

These revised proposals were brought into effect from March 1967. Close on their heels, the central government granted special ways and means advances of over Rs 59 crores to enable states to repay all their outstanding overdrafts. Thanks to the last, central assistance to enable states to clear their overdrafts came to nearly Rs 237 crores between June 1965 and March 1967.

The new limits and the clean slate initiative were followed by a conference of chief ministers and finance ministers convened in Delhi at the beginning of April 1967 at which Bhattacharyya underlined the need to avoid overdrafts and explained the steps the Bank proposed to take against states failing to restore order to their accounts. There were limits, he stressed, to how far the Bank could 'continue to carry in its books an operation which is illegal under the Statute'. However, despite the reforms and the threat of their payments being stopped, state governments continued to overdraw on the Bank, and by

November 1967 overdrafts had climbed steeply to Rs 65 crores. Earlier in October, the Deputy Prime Minister, Morarji Desai, had advised the Bank not to balk at stopping payments of states failing to get out of the red. Preliminary exercises the Bank carried out in March 1967 suggested that not all sources of leakage of funds could be plugged. Nor could state governments be allowed to default on their external liabilities. Ceasing payments would no doubt cause great inconvenience to the public and a certain amount of disaffection and unrest. Some transactions of the central government, such as the payment of pensions to its retired employees at treasuries and subtreasuries, would also be affected. But on the whole, it was possible to enforce an order to stop payments on a state government's account effectively.

However, when the decisive moment came in November 1967, the Bank drew away from any extreme measures. L.K. Jha, who had meanwhile become Governor, informed Morarji Desai that rising expenditures by state governments, particularly in the months preceding the general elections, and the market's lack of appetite for their loans had led to the financial position of some states deteriorating to an extent where 'even with the best efforts', most of them would not be able to 'muster enough resources within three weeks to clear their overdrafts'. Nor could states' payments be stopped lightly, as the move was bound to have 'serious repercussions ... of a political nature' and on the 'already dangerous law and order situation'. If 'policemen do not get their salaries', Jha pointed out, 'we cannot expect them to be on the side of law and order'. The Governor therefore suggested holding another conference of states at which their representatives could be urged to cut their plans, curtail expenditure, and mobilize additional resources.

> If after such a review a State does prove to be recalcitrant and if there is no other remedy left, the stoppage of payments may have to be a last resort remedy. However, to take this extreme step at this juncture on three weeks' notice may not be the best method of dealing with the situation.

MARKET BORROWINGS BY STATE GOVERNMENTS

Provincial governments, as the governments of states of the Indian Union were referred to earlier, were not major borrowers in the capital market in the pre-plan period. The slump in the central government's borrowing operations was matched by that in the demand for the securities issued by these governments only four of whom entered the market during 1946–51 to raise Rs 24.5 crores through eight issues. To this may be compared the Rs 41 crores raised by seven governments through 21 issues during 1940–46. All but one of the loans floated during 1946–51 were underwritten, including two by the Bank, while four others for Rs 13 crores did not come to the market because no satisfactory underwriting arrangements could be made.

Conditions remained unfavourable for state governments' borrowing operations even after the launch of the first five-year plan. However, with the need to raise resources having become rather more pressing than in the past, governments (including those of some Part B states with whom the Reserve Bank was in the process of entering into banking arrangements) began more actively to consider the possibility of floating market loans. This section gives an overview of state governments' loan operations during the years covered by this volume and discusses the Bank's role in facilitating and regulating their issues.

It was only after some controversy, and penetrating scrutiny by governments of even the Part A states, that the Bank managed to define its role in relation to their loan issues in the constitutional and political dispensation that emerged from the upheavals of 1947–50. The Bank had long been criticized in some quarters for failing to ensure uniform terms for all gilt-edged flotations and for its refusal to support state government loans in the open market or to nurse the market prior to a new state loan. But a new row erupted in March 1951 when some state governments complained that the Bank's advice to them about the size and terms of their loans merely reflected the 'restrictive authority' the central government wished to exercise over their market operations. Denying the allegation the first time it was made openly at the conference of Governors and Rajpramukhs in March 1951, the Finance Minister, C.D. Deshmukh, argued that the Reserve Bank offered its counsel to state governments independently in its role as an 'expert adviser' and on the basis of its assessment of 'their credit and the conditions of the money market'. This however failed to reassure many state governments. 'What is worse', Deshmukh observed somewhat indignantly in August 1951 about the persistence of similar complaints, it was being suggested that the centre's 'motive ... [was] to raise money from the market at the cost of state governments'. Denying that the centre had 'any such motive', Deshmukh wanted it brought to the attention of state governments that on many occasions in the past the Bank had 'advised ... the Centre also to cut down its borrowing programme', and that in 1950 'on the advice of the Reserve Bank the Centre refrained from issuing any loan at all other than a conversion loan'. Besides, although it was

> open to the Reserve Bank to refer any question for the guidance of the central government, ... it remains true to say that such guidance is not primarily influenced by the relative needs of the Centre and ... [of] the States.

The Bank agreed with Deshmukh. Yet, perhaps apprehending that it would otherwise have to shoulder the entire burden of resisting states' demands to be allowed to float large loans in an unreceptive market and unsure yet of the extent of its influence over their governments, the Bank told the central government that the latter could not afford to adopt an attitude of lofty indifference towards states' loans since these were bound to 'have repercussions on the centre's existing loans and ... borrowing programmes in the future'. A few months later, in December 1952, the Bank also pointed out to the central government, while explaining its objections to a proposal from West Bengal to raise a loan for a salt works, that the Planning Commission had been set up to 'decide upon the relative priorities' of investment proposals and oversee the 'allocation of resources'. Allowing state governments to come into the market in an uncoordinated manner to finance schemes not 'approved or formulated' by the Commission would, the Bank urged, 'necessarily entrench upon the resources available for the schemes approved under the Five Year Plan, as the total investible funds in the hands of institutions and others ... [was] limited'. A possible way out of this 'difficulty' might be to

> lay down a requirement that if a State desires to embark upon a scheme it may do so with its own resources, but if it wishes to raise funds from the market ... by the issue of a public loan or by negotiation with private investors, it must obtain the approval of the Planning Commission for the project.

We may note here in passing that the Bank however grew increasingly sceptical in later years, among other things, of the Planning Commission's targets for market borrowing by state governments.

Despite a few dissenting notes, struck notably by Madras, the political climate in December 1952 was much more congenial than at any time in the recent past to suggestions for allowing the central government to play a bigger role in determining states' investment priorities and the means of financing them. But with this desirable denouement still in the future, the Bank resolved in 1951 to give the loan programmes of the central and state governments the same careful consideration, helping these bodies to raise funds in the market to the extent possible while ensuring at the same time that a stable pattern of interest rates was maintained. The Bank's credibility in these testing times when precedents were still in the process of being established and a single wrong step might undo a great deal of effort, depended on its ability to stabilize the interest rates on government loans. While the central government was by far the biggest borrower and the Bank's relations with it were by now on a rather even keel, uncoordinated and competitive borrowing by state governments presented a possible source of danger to a gilt-edged market recovering slowly from the effects of the political tumult of 1947–50. Thus when Madras held out a threat in 1951 of raising its loan, whose size the Bank felt was too ambitious, on 'terms ... such as would attract investors adequately', the Bank responded with alacrity, enquiring of the state government whether this meant 'a rate of yield as might prejudice the pattern of other loans including [of] the Government of India ....' In the event, the Bank's responsibility for ensuring a stable and orderly pattern of gilt-edged rates came to be recognized more widely within a couple of years of this episode, with the central government letting it be known to state governments that they should either accept the 'considered advice of the Reserve Bank' as to their borrowing rates and the other terms of their loans 'or stay off the market'.

To some extent, of course, the anxiety state governments voiced in the early years about the roles of the Bank and the central government reflected the newness of the prevailing constitutional and political arrangements and the understandable desire of these institutions to test the limits of their powers and responsibilities within them. Differences of attitudes, perceptions, and expectations narrowed as these arrangements stabilized over time and as state government officials came into closer contact with those at Mint Road and became more familiar with the manner in which its market assessments were carried out. The Bank too, learned to take the compulsions of state governments in its stride and as well as assisting their issues, played an important role in promoting the popularity of this class of gilt-edged stock among commercial banks. In later years especially, the Bank made conscious efforts to create a level field for the loans of all states. This was judged necessary since the significant commercial or financial centres were all concentrated in a few regions and left to itself, the market tended to be biased in favour of some states' loans. It is also an apt illustration of the Bank's approach towards the borrowing plans of state governments as the former evolved in the 1950s and 1960s that, while never ceasing to exhort them to borrow wisely and spend carefully, the Bank rejected a proposal the central government made in 1964 to restrict state governments' access to the market. The Bank argued that besides violating an important constitutional principle, the proposal would, if implemented, limit the range of gilt-edged stock available in the market and weaken the attraction of these instruments for institutional investors such as commercial banks.

On the other hand, differences between the Bank and states did not altogether cease during these years. The size and terms of state loans often proved contentious. In addition, differences cropped up over the size of the Bank's contribution to state loans, the manner in which states mobilized subscriptions, and the extent to which they could retain excess subscriptions to their loans. Difficulties of communicating between Delhi, Bombay, and the state capitals made it harder for the Bank to ensure complete coordination with state governments whose officials were not above exploiting these difficulties to try to have their own way vis-a-vis the Bank.

The Planning Commission's propensity during these years to persuade states to step up the size of their plans was another complicating factor. In 1956, when loans of several states went to substantial discounts soon after they closed and the Bank stepped in heavily to ensure the success of the West Bengal loan, B.C. Roy, the chief minister of West Bengal, insisted that the Planning Commission was responsible for this state of affairs since it had placed his government in the unenviable position of having to borrow Rs 7 crores every year during the second plan. Iengar averred that the Commission did not consult the Bank about the size of the loans state governments might raise. Indeed it was not

> within their province to advise on the amount which can be raised by state governments in the market in any particular year. The competent authority in this matter is the Reserve Bank which is in close and intimate touch with the market.

But the Planning Commission too, washed its hands of the matter, pointing out to Roy that the actual size of a state's loan had to be determined by the Bank and the Finance Ministry and that its own role was limited to indicating the magnitude of resources each state had to find for its plan. The mode of financing the latter, the Commission maintained, was largely for the states to determine. Attention was drawn in an earlier chapter to the manner in which the Planning Commission was disposed to approach the problem of finding resources for the five-year plans. Thanks to this and the reluctance and limited ability of state governments to raise resources through taxes and small savings, the Bank was frequently in the position of having to advise them to limit their borrowings and therefore to curtail their plans to the extent of the resources they could mobilize. However, from the early 1960s in particular, the Bank was able to line up the Finance Ministry behind its efforts to limit state governments' borrowing programmes to amounts which, in its judgement, the market could absorb. As well as sharing to some extent the Bank's concern for the state of the gilt-edged market, the Finance Ministry also had reasons to be worried about the consequences of over-borrowing by the states for its own loans and future borrowing prospects.

The Early Years

Since 1938, the practice had prevailed of underwriting loans issued by provincial governments. The system of underwriting proved useful in the initial stages, but a feeling began to develop by the late 1940s that it placed provincial governments at a disadvantage and prevented them from 'getting what little they would have got' through a 'straight public issue'. According to some officials at the Bank, the underwriting procedure made for excessive rigidity:

> either the loan will have to be issued at the lowest rate quoted by the underwriters to secure the full amount ... even though a good portion of ... [it] might have been tendered at more favourable rates, or the loan issue ... abandoned altogether.

Besides, if states had to 'reach any stature at all, they should get educated' about the market's evaluation of their credit. It was only too easy otherwise, according to the Deputy Governor, N. Sundaresan, to persist with the 'sheer camouflage [of] paying terrible discounts [of 6 annas per cent which were often passed on to the subscribers] to borrow modest amounts'.

Proposals were mooted within the Bank to discontinue the practice of underwriting state government loans in 1950 but to little immediate effect. The following year, five state governments, Madhya Pradesh, West Bengal, Bombay, Madras, and Uttar Pradesh, proposed to come to the market with loans for Rs 15 crores. These proposals together presented a formidable challenge to the Bank. The advent of planning had clearly emboldened some states to propose a borrowing programme which was the most ambitious yet of any they had ventured since the end of the war. Few could question the urgency with which governments wished to promote the economic development of these large and very important states, especially after the inception of the planning process. But the Bank had also to be mindful of wider considerations to which individual state governments, even when they were led by men of acknowledged political and personal stature in the public life of the new republic, would not normally be sensitive, without appearing to be out of step with their developmental aspirations. On the other hand, since these were still early days for the new constitutional arrangements, the manner in which it handled the 1951 borrowing proposals was certain to affect the future of the

Bank's relations with the states of the Union and its own role in the emerging scheme of things.

Officials at the Bank were generally sceptical that the states would be able to borrow any money at all in the market, let alone the Rs 15 crores they sought. But the Bank was content to whittle down the size of the programme to Rs 10.75 crores. The prospects of raising even this amount appeared dim after an informal meeting Rama Rau convened of underwriters and brokers dispersed amidst 'general feeling that no combination ... [of them] would be able to conjure up more than a crore of rupees ....' Thus, while the state governments, four of whom wanted their loans underwritten, faced a choice between risking a 'straight' loan and not borrowing at all, the Bank could either discontinue existing underwriting arrangements and float the loans with its support, or abandon the programme itself and along with it, a good opportunity to promote its influence over the public borrowing decisions of state governments.

There were, in the view the Bank held at the time, major obstacles in the way of state governments raising loans in the market. Their securities appealed to a 'limited clientele' who preferred yield to liquidity, while small banks and insurance companies bought them only because the borrowing governments forced them to do so. Since those who bought states' loans unwillingly took the first opportunity thereafter to sell their holdings of them and the latter often represented a 'large proportion ... [of] the ... debt', the market quotations of these loans tended to sag immediately after they closed. The big banks did not hold state loans. Nor did the Reserve Bank hold or buy them save in rare circumstances such as which prevailed in the summer of 1947. Convinced that purchases by the Bank were inflationary and gave state governments a 'false impression' of the popularity of their loans, officials at Mint Road refused at first to entertain the possibility, Sundaresan for example, remarking that the Bank would 'become an asylum' for states' loans if it began extending buying support to them. Open-market operations would no doubt help improve the liquidity and strength of states' loans, but there was little immediate prospect of undertaking them unless state governments agreed to bear the resulting losses.

If the prospects for states' loans appeared difficult in 1951, floating 'straight' loans was nothing short of a gamble. But the Bank's was not the final word, and with state governments determined to come to the market, it was decided to 'abandon the idea of underwriting states' loans' that year and advise all state governments to float 'straight loans in the market' for realistic amounts and at reasonable rates. Feeling that the time had come to 'give a bold and honest indication of stepping up interest rates', the Bank also advised the states to offer modest amounts—'to aim too high and achieve too low may jeopardize ... credit [and] ... future borrowings'—in eleven-year loans at coupon rates of 3.5 per cent. Besides, braving further criticism, it asked the government of Madras to price its issue at 4 annas and the governments of Uttar Pradesh and Madhya Pradesh at 8 annas below par. The Bombay and Bengal issues were to go out at par. The loans were also scheduled now to open towards the middle of September, shortly after a central government loan (the 3 per cent 1951–54) was discharged, so that its proceeds might find their way into the new issues.

As the date for announcing the 1951 states loan programme drew near, there was a growing fear of failure within the Bank and some debate about its role in the event of public subscriptions falling short of the issued amounts. Sundaresan even put in place arrangements to enable the issue to be called off, if necessary even hours before its announcement on 10 September, for fear that 'otherwise [state governments may] ... blame the Reserve Bank for having recommended the flotation of loans which proved to be complete flops'. There were also differences within the Bank about its responsibility for the success of these loans. Arguing that state governments faced difficulties in selling their holdings of central loans and that having recommended the present course, the Reserve Bank owed it to the states to 'go to their succour' if public subscriptions fell short of the recommended amounts, Rama Rau was in favour of the Bank putting about Rs 2 crores into the loans. His deputy took the more orthodox view. Bank financing of market loans amounted to 'inflationary' financing, and the amounts it recommended to state governments represented 'targets ... not an assured minimum'. If the public response turned out to be poor, Sundaresan declared, 'it should be treated as part of the day's game'. Besides being unsound, the course proposed by Rama Rau was bound to strengthen the 'fantastic notions' states already harboured about their credit. The differences between Rama Rau and Sundaresan went up to the Finance Minister who, while generally assenting to the orthodox principle Sundaresan espoused, felt there could be no objection to the Bank distributing Rs 2 crores over the five loans 'so long as no particular loan ... [was] over-supported in this way'. The Bank's assistance, the central government pointed out, would help 'maintain some strength in the market [and] ... a cordial relationship between the Reserve Bank of India and the State Governments'.

In the event, the announcement went off without a hitch on 10 September and the loans opened and closed on 17 September after total subscriptions of Rs 10.97 crores. Thanks to some favourable conditions, including the maturing of the central loan, large interest payments made on other loans around the time of the issue, and the absence of any internal or external political or economic crisis, total *public* subscriptions exceeded the Bank's expectations. But despite 'even ... the greatest pressure ... exerted by the state authorities concerned' on investors within their states, these fell short of the target by over Rs 3 crores, the Bengal loan being the only one to be taken up in full by the public. The shortfall in the case of the other loans was made up by contributions from the Bank (Rs 1.52 crores) and from the state governments themselves. The Madras government, to which the Bank had recommended Rs 3 crores and which even days before the announcement wanted the loan amount raised to Rs 4 crores, citing among other factors the presumed willingness of a well-established local bank to underwrite the entire issue for sale at par, managed Rs 2 crores. Madhya Pradesh which indented for Rs one crore performed the worst, getting only about an eighth of that amount. The poor performance of the state loans, Sundaresan concluded somewhat rashly, meant 'it would be most inadvisable to launch ... large ... projects on the assumption that this country will be flowing with milk and honey' in the coming years.

Whatever the Bank's preferences, several large investment projects were on the anvil in the states, and their need consequently for resources and recourse to the market only increased in subsequent years. But as it happened, the practice of underwriting state loans was never revived. Although not so intended, the decision to abandon underwriting and the related move by the Bank to contribute substantially to making up the shortfall in public subscriptions to the four state loans in 1951 helped greatly to enhance its influence over the loan programmes of state governments in the next few years.

The following year the Bank felt state governments would stand a better chance if they were allowed to come to the market before the central government. The latter accepted the Bank's advice in the first instance, but did not in the event float any loans in the market during the year. The Bank also proved more willing on this occasion to let the states determine the size of their borrowing operations so long as they were confident of the strength of the local sentiments in their favour. The Bank's new stance was largely a response to the Madras chief minister, C. Rajagopalachari's suggestion that he should be allowed to take a gamble on a larger loan than the one the Bank was prepared to consider. Apart from the popular enthusiasm created by the development programmes his government had launched in the state and its success in mobilizing loans from farmers and other 'small men' for its irrigation schemes, Rajaji maintained that in 'sheer self-interest, if not on nobler impulses, ... the money-bags ... [would] hasten to strengthen ... [his] hands' by subscribing to the loans floated by the state. But while not standing in the way of state governments' loan proposals, the Bank resolved to distribute its own subscriptions 'impartially' and not 'give any undue preference to any one state'.

In the event, four loans were issued initially in 1952 for a total of Rs 12.5 crores. The loans were generally a success, the Madras loan of Rs 5 crores, in particular, being oversubscribed to the extent of Rs one crore. The success of the Madras loan raised a fresh set of problems as the state government wished to retain the oversubscribed amount for its ways and means needs. Subscriptions to the loan, Madras officials argued, represented a 'moral asset' for the chief minister and his government which should not be 'frittered away'. Finding no reasonable means of implementing it, the Bank initially opposed the state government's proposal. The loan had been raised to finance electricity schemes and productive irrigation works and it would not be 'proper to use it for any other purpose' even if in practice there were 'no means of discovering how ... [a] loan ... [was] utilized', as doing so might 'provoke criticism and ... destroy public confidence'. However, because of the state government's precarious ways and means position, the central government too was keen to find some way of letting Madras keep the additional money, and Deshmukh felt the 'altered circumstances' necessitated 'readjust[ing] ... attitudes in a matter like this'. At Deshmukh's instance the Bank advised the Madras government to reissue its loan against the excess subscriptions, but this advice could not be carried out since it came after treasuries in the state had already returned a major portion of the oversubscription from the public.

There were, perhaps unavoidably, some inconsistencies during these early years in the Bank's approach towards state governments' loan flotations. To an extent, no doubt, this was because not all states were yet equal either constitutionally or in terms of the market ratings of their loans. But the inconsistencies extended beyond these factors and arose too from the relative novelty of the process the Bank was in the midst of learning to administer. It was pointed out above that officials at the Bank demurred when West Bengal wanted to place a loan for Rs 2 crores in December 1952 for a project which was not included in the five-year plan. But it allowed the 1952 loan programme of state governments to drag on till March 1953. First in December 1952 and again four months later, Uttar Pradesh applied to the Bank to be allowed to issue to the Punjab National Bank Rs 4 crores in all of its new 4 per cent 1964 loan. 'Piece-meal issues' such as these, the Bank felt, were 'contrary to the terms of the original notification' and not a 'healthy practice'. Besides, officials at the Bank noted in March that the Punjab National Bank had borrowed large amounts from the Reserve Bank at 3.5 per cent, so that to some extent it was using the latter's funds to earn half a per cent's interest for itself. Four per cent loans were also quoting at a premium while the UP loan was proposed to be issued to the Punjab National Bank at par. But with the state government, which had not issued any loans for three years before 1951, needing the money and being 'very keen' to borrow from the Punjab National Bank 'in spite of these considerations', the Bank decided not to stand in its way. In this case, unlike in the case of the West Bengal proposal, the Bank did not consider the uses to which Uttar Pradesh intended to put the proceeds of its loans and whether these formed part of the state's plan. But it turned down a request from Mysore—a Part B state—in August 1952 to be allowed to raise Rs 3 crores to finance plan projects on the ground that there was no market for it.

In all eleven states, including for the first time five Part B states (Mysore, Saurashtra, Madhya Bharat, Travancore-Cochin, and Hyderabad), entered the market in 1953 with 4 per cent ten-year loans aggregating Rs 31 crores. Once again the terms of the Madras loan posed some dilemmas for the Bank and the central government. Since the state was soon to be bifurcated, it was decided after some debate to raise the Madras loan on behalf of both the successor states, with buyers being asked to indicate the state for which their subscription was intended. The Bank had originally proposed issuing the Bombay and West Bengal loans at par, the Madras loan at Rs 99-12, and the remaining loans at Rs 99-8. But the Bank's judgement was challenged once more by Rajagopalachari who insisted that the Madras loan should not be priced higher than the Mysore and Travancore-Cochin loans since the three states were 'linked together commercially'. The Bank opposed the idea. Travancore-Cochin, it felt, was financially 'in a bad way and up against communist propaganda' and, despite Rajagopalachari believing only he stood between 'Madras and anarchy', the credit of the two states could not be equated. The time had also come to be 'firm with States ... and ask them, if they are not agreeable to our advice, to go off the market'. But the central government had little stomach at this time for a confrontation, its officials fearing Rajaji would only 'create further trouble' if he was not allowed to have his way. Not only did Madras have large outstandings both to the centre and the Bank, it was also essential to keep the state's mercurial chief minister in good humour if the proposed bifurcation plans were to go forward smoothly. Hence while affirming the principle that the Bank's advice as to terms was generally binding on the borrowing states, Rama Rau acceded to Rajaji's request to knock 4 annas off the issue price of the Madras loan.

The 1953 programme was more ambitious than anything the Bank had attempted earlier on behalf of the states and there were naturally some apprehensions about the size and scope of the year's operations. But the loans were a handsome success, with total subscriptions amounting to Rs 40 crores. The Madras loan alone was subscribed more than twice over, gathering over

Rs 10.5 crores against an indent of Rs 5 crores. On the other hand, the Mysore and Travancore-Cochin loans fared quite poorly early on, the former for example attracting subscriptions of only Rs 62 lakhs in the first few days out of a loan issue of Rs 3 crores. But with the Madras loan attracting an overwhelming response, the state government decided in consultation with the Bank to close the loan in advance of the notified date, Rajaji thereafter appealing to the public to divert their funds to the Mysore and Travancore-Cochin loans.

The issue of allowing states to retain their excess subscriptions arose again in 1953. The practice until that year had been for states to retain subscriptions up to 5 per cent in excess of the notified amount. Prior to the year's loan flotations, this was raised to 10 per cent. But Madras made an effort once more to retain the entire subscription for its loan. 'It seems sad to give back money which subscribers definitely wanted to give us for our ways and means', Rajaji remarked in a letter to Rama Rau. The Bank independently came to the conclusion that there was 'considerable force' in Rajaji's argument. The issue document for the Madras loan had promised full allotment to all those who subscribed Rs one lakh or less. Since such subscriptions alone amounted to Rs 6.5 crores when the loan closed on 23 July, a 'peculiar position' had arisen wherein 'those who had put [in] applications for more than Rs one lakh were ... not entitled to any allotment whatever'. The Bank therefore felt the need to devise a procedure which did not entirely exclude the larger subscribers, and at its suggestion the central government acceded to Madras's request to enable those who had put in for more than Rs one lakh to be given full allotment unless they applied for a refund of their subscriptions within about a week of the closing of the loan. This unprecedented step sparked off protests in the press and from the stock exchanges, the Calcutta Stock Exchange Association for example pointing out that the terms of the issue were 'irrevocable' and that 'public morale and confidence' depended on their inviolability. Besides, as in the past, the Madras government had secured subscriptions

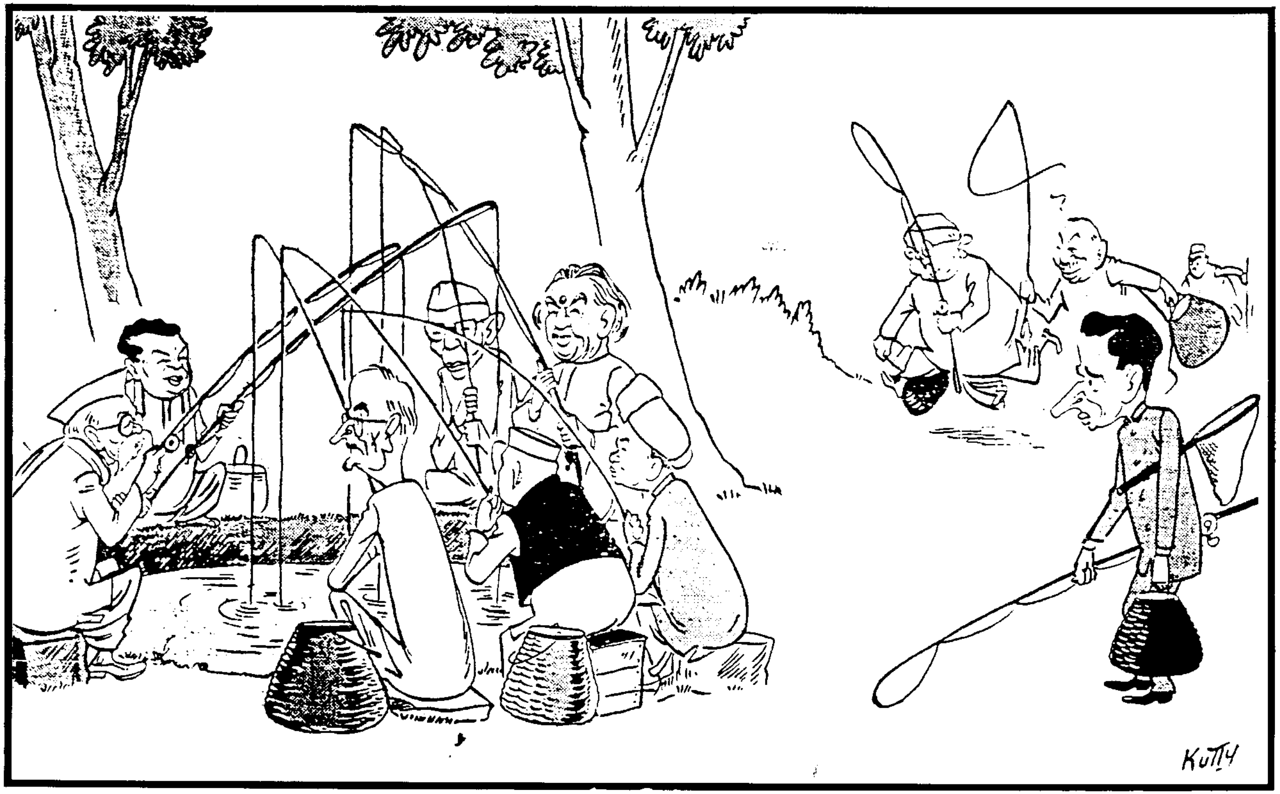
> by holding before the Insurance companies and others the threat of nationalization and imposing on the District Officers and other big people compulsory quotas .... If indeed in the present condition of the capital market languishing under lack of investible funds, state governments be allowed to squeeze the limited resources of the capital market as the Madras Government are doing ... then it will certainly be difficult for the Union government as also the industrial enterprises in this country to borrow their requirements later on from the market which is already in a dried-up condition.

But the decision having been taken, the central government defended the Madras government's action as being 'correct taking all factors into account'. The Bank however had learnt its lesson. Officials reconsidered their earlier advice and came to the conclusion that allowing Madras to retain excess subscriptions was 'not only against the established convention but was also wrong in principle'. Consequently, they did not entertain requests from the state government to be allowed to repeat the 1953 precedent three years later. Madras was instead asked to float another loan after a few weeks, tailoring it if necessary to meet the needs of small investors whom, in this instance, the government purportedly did not wish to disappoint.

As it had done the preceding year, the Uttar Pradesh government approached the Bank once more in November 1953 to be allowed to make a special issue of Rs 2 crores to the Punjab National Bank of its 4 per cent 1963 loan, at a price of Rs 99-8, against a market price of Rs 99-12. The Bank objected to the proposal. The Punjab National Bank, it was now reported, invested in UP loans in return for securing the deposits of municipal local bodies and quasi-government organizations in the state. The bank already held over Rs 2.5 crores of the UP government's 1964 loan, and the latest proposal amounted to using 'one chosen bank ... to finance the whole reissue' and making 'a present' to it of the difference between the proposed issue price and the market price of the loan. Besides, in the Bank's view, 'the propriety of any single ... bank holding such a large parcel of securities which are not readily marketable' was 'seriously open to question'. Much to the surprise of officials who apprehended 'political considerations' would force Delhi to back the Uttar Pradesh proposal, the central government sided with the Bank and the state government was asked not to sell its stock to the Punjab National Bank except at the prevailing market price.

As pointed out above, the states (with the exception of Mysore and Saurashtra) and the central government floated a combined loan in 1954. The following year marked the return to the earlier practice of separate central and state loans and plans were made initially to float a ten-year loan carrying a 4 per cent coupon rate. However, by July 1955 some 4 per cent 1963 and 1964 loans were being quoted at premiums of up to one rupee or more, and a ten-year loan did not make sense unless it was issued at 3.75 per cent. Not willing to experiment with interest rates, however, the Bank decided to increase the maturity of the loan from ten years to twelve while keeping the coupon rate intact. The 4 per cent 1967 loan was floated in August 1955 for an aggregate amount of Rs 35.75 crores. The loan was to have been kept open for two weeks, but it was so heavily oversubscribed that it was closed within as many days. The Bank had intended 'as a concession' to contribute up to 15 per cent of the subscriptions in the hope of being able to sell its acquisitions over a

"Nothing Left for Me?"



Seven State Governments have announced a second issue of their Loans.

– *Shankar's Weekly*, 28 Aug. 1955

period of time, but such support did not prove necessary. The response to the August flotation encouraged seven states to float a second tranche for Rs 11.75 crores on the same terms. This loan too was oversubscribed. Total subscriptions to these two tranches amounted to Rs 67.8 crores, against the notified amount of Rs 47.5 crores. The amount retained by the borrowing governments aggregated about Rs 55 crores.

Emboldened by these results, fifteen states (of whom Punjab, Orissa, and Rajasthan were entering the market for the first time) proposed borrowing Rs 64 crores in September 1956 through 4 per cent twelve-year loans (Bombay alone floated a fourteen-year loan at this rate) issued at prices ranging from Rs 99.25 to par. Though there was some uncertainty in the air because of the impending reorganization of states, total subscriptions amounted to Rs 74 crores of which Rs 68.7 crores were allotted.

The success of the states' loan programme in 1956 was, however, more apparent than real. For one, the Bank had to intervene heavily in some cases, having for example to buy a fifth of the West Bengal loan before it could be declared a success. Certain other loans including those which were oversubscribed went to a discount even before the lists were closed, as those who bought them to oblige insistent local officials took the first opportunity to sell. Banks which had financed the purchase of some states' loans—scheduled banks' advances against state government and other trustee securities rose by Rs 22 crores during the course of September 1956—too began recalling their advances as the busy season got under way, forcing investors to unload their securities on an unwilling market. So much so, by November 1956 some state loans were quoting at a discount of Rs 1-14 on their issue price.

The fall in the prices of state government securities in September 1956 was not altogether unexpected. The Madras government, for example, had earlier warned the Bank to expect large sales until the loans bought in response to 'intensive canvassing' by its officials 'found their way to more permanent resting places'.

> Whatever be the orthodox views on this form of salesmanship, we have to recognize the fact that the method has proved effective for hard-pressed states and will therefore be repeated. It is therefore prudent that we devise correctives to ensure that the bonds do not slump immediately after issue and thereby prevent avoidable loss to fugitive investors.

The 'corrective' Madras suggested was for the Bank to finance market intervention with the unutilized portion of the funds it had set aside for buying state government loans at the time of their issue.

State government loans going to a discount soon after they were sold was a common enough occurrence and one of long standing, but the extent of the fall in their prices in 1956 took the Bank by surprise. The fundamental problem, as officials at the Bank saw it, was that the market was in no position to meet the ambitious loan targets of state governments, while some of the latter, as we observed above, were inclined to blame the Planning Commission for this state of affairs.

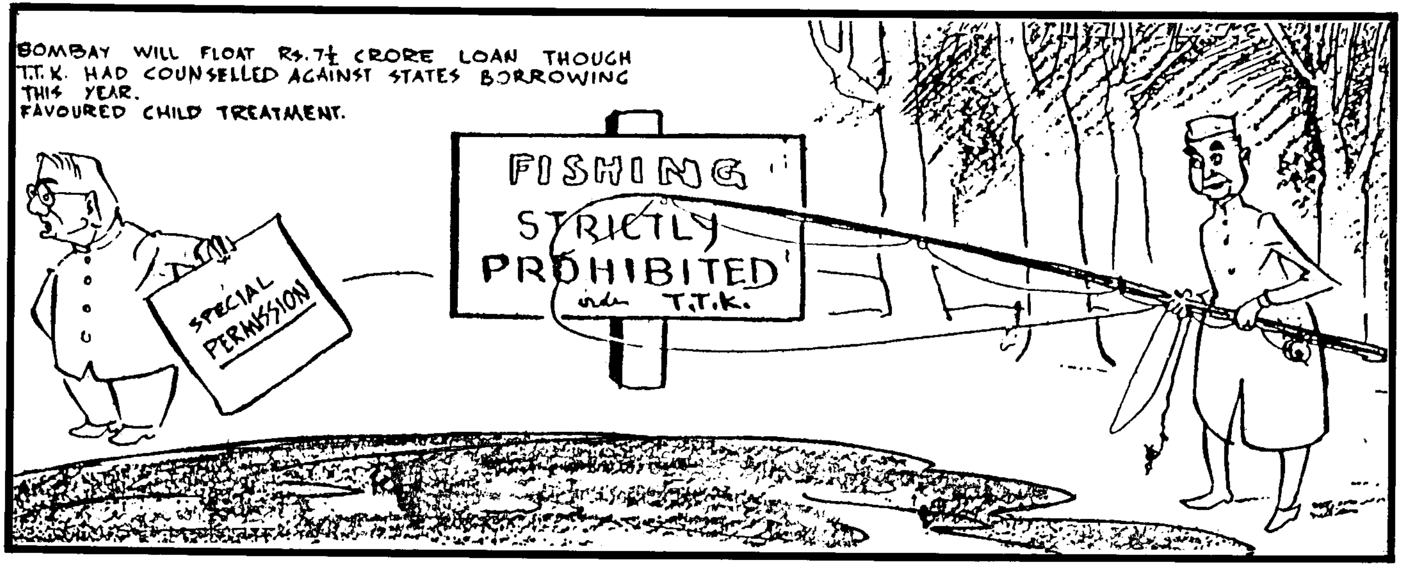
The Bank was far from keen to intervene in the market to stabilize the prices of state government securities. The problem was not confined to Madras alone and there were floating stocks of Rs 15 crores or more of several states which were thought to be contributing to the depressed state of the market. The responsibility for managing the price of their stock, the Bank felt, lay principally with the state governments who did not lack the resources, whether in the form of Government of India securities in their cash balance accounts or balances in their sinking funds, to invest in their own loans. Buying intervention by the Reserve Bank on its own account was ruled out because there was no 'reasonable prospect' of its being able to 'dispose of the purchases to the market in the near future' and the Bank's intervention would therefore merely amount to 'financing ... state governments with created money'. Although repurchases by the issuing government amounted to recognizing its failure to raise the full amount of the loan, it was 'better to adopt this course than to ... risk ... depreciation [in the market price of the loan and] ... future borrowing'. In the event, the Bank intervened to steady the prices of a few

TTK addressing state finance ministers at the Bank, Bombay, 23 June 1957. Iengar is seated next to him; at the extreme left is D.R. Gadgil, a Director of the Central Board.

state loans during the course of the year after the concerned governments placed funds for the purpose at its disposal.

With the 1956 loans still weighing heavily on the market, the Bank counselled state governments against issuing fresh loans in 1957 and to concentrate their energies on collecting small savings. In the beginning, Krishnamachari felt it would be 'politically very difficult to take a strong line with state governments' and place an embargo on their loans, or even to 'fix an upper limit for each state'. While the central government pondered its next step, states made plans to come to the market with loans of nearly Rs 50 crores, Madras alone setting its sights on Rs 10 crores. Iengar discussed the issue with a few finance ministers but no state (with the possible exception of West Bengal) appeared willing to eschew market loans during the year. The central government on the other hand, was slow to appreciate the gravity of the situation or the latter's implications for its own loan programme. Many states such as Madras and Andhra, the Bank felt, would be unable to raise much money unless they offered at least 4.5 per cent and used other methods to persuade investors in the bargain. Once the markets learnt about the states coming in at 4.5 per cent, the central government loan 'would become a flop' at 4 per cent, while the use of pressure to raise subscriptions for state loans would only demoralize the market further. State governments maintained for their part that unless a loan could be managed, they would either have to slash their plan outlays—which was 'very difficult and contrary to the express intentions' of the central government—or take recourse to deficit financing. C. Subramaniam, the finance minister of Madras, admitted 'quite frankly' to the Governor that he preferred 'getting a state loan through the use of pressure' to 'facing ... general disruption of the economy by increased deficit financing ....' The former would 'at worst ... have the same effect as a tax' and make the state government unpopular. But higher rates of inflation spelt both disorder and unpopularity. Conveying the views he had gathered from his meetings with several chief ministers and finance ministers of state governments, Iengar told the centre that a situation had now been reached in which 'the states and the centre must take concerted action in the matter of raising loan resources', and advised Krishnamachari to convene a conference of some finance ministers and the Bank to discuss the issue.

This conference, whose chief claim to fame has hitherto rested on what transpired outside its formal sessions (Krishnamachari having purportedly given his consent to investing the funds of the Life Insurance Corporation in Haridas Mundhra's concerns during an adjournment in its proceedings), convened in Bombay in June 1957 to hear both Iengar and the Finance Minister advising states to keep off the market during the year. In return they



– *Shankar's Weekly,* 14 July 1957

were promised a two-thirds share of the cash receipts under the small savings scheme. Krishnamachari, who was by now quite alarmed that large state loans would hamper his own borrowing programme, went further than the Bank wished to venture, and warned states proposing to issue loans that banks would be advised against buying them or financing others to buy them. These warnings had the desired effect and only two states—Bombay and Mysore—floated loans in 1957 for Rs 6 and 3 crores respectively. Subscriptions totalled Rs 12.7 crores, of which Rs 9.9 crores were retained by the two governments.

The Boom and Slump in State Loans

The dearth of state loans the preceding year and easy monetary conditions led to a strong and persistent demand for government securities in 1958. Ten states came to the market in July 1958 and one in October with loans amounting to Rs 50 crores. Some controversy erupted over reports from Andhra Pradesh of subscribers who had been pressurized into buying securities offering them to brokers at a discount of 75 paise even before the loan opened formally to public subscription. The Bank took a firm stand, asking the state government to put an end to this practice or risk forfeiting its support for the loan. The threat worked, with the state government instructing officials not to use 'undue pressure ... to secure subscriptions' to the loan. It also initiated arrangements to buy back the loan from those who wished to sell, in order to maintain the price. In the event, subscriptions to the two issues totalled Rs 65.8 crores, of which Rs 54.4 crores were retained. Easy conditions persisted the next year as well, with the twelve-year loans amounting to Rs 63.5 crores floated in August 1959 by thirteen states at a reduced coupon rate of 4 per cent evoking an 'astonishingly good' response in the market. Loans of eleven of these states (including Kerala which first decided to stay off the market after local bankers refused to support its loan in protest against the debt relief legislation passed by the state government, but which decided to approach the market after coming under President's rule) were closed on the very first day, while the other two were able to close their loans the following morning. Total subscription amounted to Rs 102.4 crores, but only Rs 69.5 crores could be retained. Although the central government disapproved of the suggestion because other states might react adversely to it and there were some differences within the Bank as well, the Madhya Pradesh government was allowed at the Deputy Governor, K.G. Ambegaokar's instance to take advantage of the 'favourable investment demand and make a lasting improvement' in its ways and means by floating a second tranche of its loan for Rs 2 crores.

The recent success of state loans led the Bank to consider lengthening the currency of this category of securities to fifteen years and narrowing the spread between their coupon rates and those on central loans to a quarter of a percentage point from the prevailing half. But such ideas were soon thrust into the background as the gilt-edged market slid into a morass in 1960. A nine-year loan at 4 per cent was the best the Bank could recommend to the dozen states who entered the market for Rs 75 crores in August 1960. Collections aggregated Rs 85.5 crores, but satisfaction at this outcome was clouded by the realization that commercial banks financed their subscriptions out of borrowings from the State Bank and the Reserve Bank, and by reports from some states, particularly Andhra Pradesh, that the local authorities had once again used 'pressure tactics for enlisting public support' for their loans.

The inaugural year of the third five-year plan saw a slight levering up of the coupon rate to 4.25 per cent on the eleven-year state loans issued in 1961. Thirteen states floated loans totalling Rs 80 crores, and though some loans required support from the Bank, the Life Insurance Corporation, and the State Bank, actual subscriptions totalled Rs 92.2 crores of which Rs 87 crores were retained. The Andhra Pradesh government took the unusual step of asking its collectors and treasury officials to begin accepting deposits from intending subscribers without waiting for the state loan to open. It was common enough for state governments to informally canvass banks and other institutions for subscriptions before their loans opened or even before they were announced. But this was the first instance of a state government allowing its loans to open informally before the notified date. The Bank protested Andhra Pradesh's attempt to sidestep its own loan notification in this manner, and demanded the withdrawal of the offending instruction as a price for going ahead with the loan. But since advance subscriptions to the loan had already begun to flow in, the Bank could do little in the matter other than refuse to accept them at its own offices and warn the state government to desist from such practices in the future.

The following year, 1962, saw a further increase in the coupon rate on state loans, to 4.5 per cent. All the states with the exception of Jammu and Kashmir entered the market with twelve-year loans for a notified amount of Rs 93.5 crores at issue prices ranging between Rs 99.50 and Rs 100. Subscriptions totalled Rs 109 crores of which Rs 100.7 crores were accepted. After a year's flirtation with combined loans, a dozen states returned to the market in 1964 to raise Rs 100 crores in the form of twelve-year loans which now carried coupon rates of 4.75 per cent. The Bank had once more to come to the rescue of some states, on this occasion of Madras and Maharashtra, but the issue succeeded in mobilizing Rs 109.6 crores.

In 1965–66, which was the terminal year of the third plan, states planned to raise Rs 108 crores, but a major inhibiting factor was the Bank's decision to discontinue subscribing to state loans as part of the government's 'rigorous and exacting disinflationary policy'. The Finance Ministry wanted states to exercise restraint in their borrowings while the Bank too thought it had become necessary to 'check ... the demands' of states which were 'expanding too rapidly'. This proved difficult in practice because a majority of the fourteen states intending to enter the market proposed borrowing relatively small amounts of Rs 4 crores to Rs 9 crores. However, the Bank decided that it could not, 'in keeping with its overall responsibility for sound monetary management', extend any support to state government loans that year. Despite this, all fourteen states entered the market in August 1965 with twelve-year 5.5 per cent loans amounting to Rs 101 crores. Public subscriptions fell well short of the targeted amount. The Finance Ministry stuck resolutely to the view that leaving their loans undersubscribed would send the right signal to state governments and force them to be more modest in their demands on the market in the future. The Bank too remained firm that its resources should no longer be used to support state loans. But at the same time, it wanted to avoid advertising the failure of the loans programme, and Bhattacharyya intervened to ensure that the states distributed the unsubscribed portions of their loans among themselves. Total subscriptions amounted in the end to Rs 107 crores. Of this nearly Rs 22 crores were contributed by the various state governments who proved no less eager than other involuntary investors in the past to sell their holdings at the first opportunity. Consequently, the state loans floated in 1965 went to sizeable discounts almost immediately.

With the market clearly losing whatever appetite it had had for their loans, the Bank now redoubled its efforts to persuade state governments to set modest targets and more attractive terms. One consequence of the steady increase in the size of the states' loan programme in recent years, as R.K. Seshadri (who had meanwhile moved from the Finance Ministry to become an Executive Director at the Bank) observed in 1966, was to make the 'terms of issue more and more unreal, at the cost of investors who are not in a position to resist ... local pressure'. Both the Finance Ministry and the Bank now maintained that the market borrowing figures which states settled in consultation with the Planning Commission should not be regarded as 'committing' them 'in any manner', and the Bank slashed the total size of state loans in 1966 from the Rs 118.5 crores proposed by their governments to Rs 93.5 crores. Secondly, while retaining the existing twelve-year coupon rate of 5.5 per cent, states were encouraged to issue their loans at prices ranging from Rs 98 to Rs 99—no loan being issued at par. But even the resulting redemption yields—which ranged from 5.62 per cent to 5.73 per cent—were not to the satisfaction of large institutional buyers such as the

Life Insurance Corporation of India whose Chairman urged the Bank to ensure that state loans offered terms which were 'in harmony with ... market conditions' at least at the time they were floated. But the Bank was understandably keen not to see a further rise in the coupon rates on gilt-edged stock, and preferred instead a reduction in the quantum of public sector borrowing. The real problem was 'not so much ... the rate of interest ... as that the size of the programme ... [was] much larger than it should have been'. The solution therefore lay in reducing 'the size of the total borrowing programme', the Bank concluded.

Attention was drawn above to the unorthodox methods state governments used to 'market' their loans. Initially confined to Madras and later to Andhra which soon outshone its mentor in this respect, these states' methods came to be adopted more widely from the late fifties. Where state governments were determined to squeeze the market to the last rupee, the Bank's disapproval was of generally little consequence. As the growth in their expenditures outpaced that in resources, state governments began exercising 'extraordinary pressure' on potential subscribers to their loans. By 1966 it had become common for state government officials to force businessmen, especially those 'dealing in licensed or controlled commodities', and contractors vying for public contracts to subscribe to loans or put up contributions that could be used to subsidize subscriptions by others. Despite such efforts, the year's loan programme failed to set the markets on fire. State governments once again entered as buyers in a major way, taking up Rs 24.35 crores (which amounted to a quarter of the total subscriptions) of their own or of one another's loans. Even so, the issue could be closed only after the Life Insurance Corporation and the State Bank of India agreed, at the Bank's urging, to make up the shortfall in public subscriptions.

Not surprisingly, prices of the loans floated in 1966 fell sharply within a few weeks. The Madras, Andhra Pradesh, and Uttar Pradesh loans were particularly badly hit by early sales and were soon being quoted at prices as low as Rs 91. Market reports remained gloomy and the Bank's prognosis based on them was that there was little chance of these loans rising above Rs 94 during the next few months. In fact, the Bank feared many of the loans issued in 1966 would still be quoting at sizeable discounts when state governments returned to the market the following year. The evidence was therefore unmistakeable, in its view, that the 'borrowing programme in the last two years has been considerably in excess of the market's capacity to absorb these loans'. But few state governments or the Planning Commission appeared willing to draw these lessons, with the latter suggesting to the former a borrowing target for 1967–68, which at Rs 140 crores was nearly 50 per cent higher than the amount state governments managed with great difficulty to raise the previous year.

Unpublished Sources

G.8	Governor's Correspondence with Government of India, Ministry of Finance
C.76	Central Government Loans—Policy
C.117	State Government Loans—Policy
C.66	Open-market Operations
RD.6	Rural Banking Enquiry Committee—Reserve Bank's Views
PR(R)-36	Amendments to the RBI Act
C.158	Extension of Banking Arrangements to Part B States
SY.95A	Central Government Treasury Bills—Policy
C.169	Ways and Means Advances—Policy

Memoranda to the Central Board and Committee of Central Board